Bank of Canada

Annual report of the Governor
to the Minister of Finance
and statement of accounts for the year

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Governor - Gouverneur

Ottawa K1A 0G9

28 February 1992

The Hon. Donald F. Mazankowski, P.C.
Minister of Finance
O t t a w a

Dear Mr. Mazankowski,

In accordance with the provisions of the *Bank of Canada Act*, I am submitting my report for the year 1991 and a statement of the Bank's accounts for this period, signed and certified in the manner prescribed in the by-laws of the Bank.

Yours sincerely,

J W Crow

BANK OF CANADA

REPORT OF THE GOVERNOR - 1991

GENERAL OBSERVATIONS

The Bank of Canada's annual reports, besides conveying its financial statements and an account of its activities, provide an opportunity to review economic and financial developments in the light of the Bank's monetary policy responsibilities.

These first pages aim to give a broad perspective. This is particularly important for monetary policy, because its purposes and results are far from captured within the limits of what happens in a given year. At the same time, the annual calendar does provide a chance to take stock of recent events and the progress being made in the direction we need to go.

Let me begin with the economy. As we all know, the past year has been difficult. The Canadian economy has been slow to break free from recession. What may be less widely recognized is that this sluggishness has reflected a more general problem among industrial countries. This problem has its roots in the spending/debt syndrome of the latter half of the 1980s when unsustainable levels of spending and inflationary pressures were accompanied by sharply rising debt burdens. The fallout from these excesses has been weighing on the economies of a number of countries.

The international economic environment has been challenging in other respects as well. Globalization of markets has expanded economic opportunities, but the associated rationalization of production has also added to economic uncertainties. Tensions have persisted in the area of international trade. And developments in Eastern Europe and the former Soviet Union can only increase the pressures on world savings.

The next section of this report describes how major industrial nations have been affected to varying degrees by these problems. But what should be noted here is the extent of the impact in the United States, our major trading partner, of the persistent overhang of overvalued real estate and accumulated debt burdens on governments, businesses and households. U.S. banks and other financial intermediaries have had a correspondingly difficult passage, giving rise to concerns about a "credit crunch." It was not really possible to gauge closely how much this unprecedented situation would prove to be a brake on U.S. economic activity, but in the event the U.S. economy dragged all year.

The pattern of excesses in spending, inflation and debt accumulation followed by a difficult period of recession and adjustment has been a feature of recent developments in Canada as well. Problems of this nature originating abroad have compounded those created domestically. Economic expansion did begin to revive here in the spring. There was a pickup in areas of spending, such as housing, that are particularly sensitive to reductions in interest rates. But the economy then hesitated as thc international demand for Canadian exports softened and weakness in world commodity prices persisted. Also, Canadian consumers remained cautious. Uncertainty about our economic prospects was by all accounts one factor in this caution, but the fact that Canadian households had also run up their debts to record levels through the second half of the 1980s was another. And the accumulation of public sector debt in Canada has meant that fiscal policies have needed to focus on deficit containment and reduction.

Problems like these, stemming from excesses stretching over a number of years, by their very nature do not have quick solutions. At the same time, it is worth underlining that progress was made in 1991 in overcoming these imbalances, and their drag on economic activity should be correspondingly less in 1992 and beyond.

In Canada, one major change as we enter 1992 is that interest rates are much lower than earlier. This is a step in a good direction. Its effects are already being felt. And it is important.

Few will question this. The challenge is whether interest rates can come down still lower, with the prospect of staying down.

It cannot be stated too often that the only way to achieve generally low interest rates is through lower rates of inflation and widespread confidence that inflation will not be allowed to be a threat in the future. The past year has provided useful evidence of this. Interest rates have fallen across the entire maturity spectrum, because people have increasingly come to believe that Canadian money will hold its purchasing value. Indeed, rates on bank loans and mortgages have been lower than Canadians have seen in nearly 20 years. Further progress can be achieved as confidence grows that monetary policy will continue to follow a path towards price stability.

Building confidence in the economy through monetary policy

In times like these it is particularly important to provide a clear perspective on what public policies can contribute in a lasting way to the economic health of the country, because no one policy can simultaneously address all our challenges.

The unique contribution that monetary policy can make is to provide money that can be used with confidence across the whole economy. Only when money holds its value will it hold confidence. Therefore, the guiding principle for Canadian monetary policy has been to seek a rate of monetary expansion consistent with ensuring that the value of money is not eroded by inflation.

This is important. As explained in detail in last year's Annual Report, the costs of inflation are pervasive and significant. A policy that tolerates inflation makes it more difficult for our economy to realize the basic goals of sustained high employment and rising living standards. And because the costs of inflation do not fall equally on all Canadians, it is unfair and socially divisive.

However, fostering a climate of price stability does take time. Given the protracted inflation in this country in recent decades, there has been a buildup of inflationary reflexes and an accumulation of decisions taken in the expectation that inflation was bound to persist. Furthermore, in the late 1980s we lost ground in curbing inflation on account of the boom in spending and the overheating in many sectors of the economy. Therefore, much of the effort of monetary policy in recent years had to be directed at retrieving this ground. In these circumstances there has been a good deal of scepticism about the likelihood that price stability would be achieved in Canada.

To provide Canadians with a clear affirmation that price stability remains the goal of monetary policy and an indication of the time path for meeting that goal, formal targets for reducing inflation were announced jointly by the Bank of Canada and the Government of Canada in February 1991. These targets are detailed in the section of this report dealing with Bank of Canada activities. In recognition that reducing inflation requires a gradual, but progressive, approach stretching over several years, the targets set out the downward path for inflation that monetary policy will aim at over the medium term.

Many people understand that inflationary policies are damaging to the economy. But it is nonetheless an article of belief among some observers that price stability, trust in the value of money, means high unemployment. This is clearly not the case. In Canada, during much of the 1950s and 1960s, a situation of virtual price stability was accompanied by high employment and strong output growth. And in countries like Japan and Germany, policies to preserve price stability have gone hand-in-hand with good overall economic performance. In our current circumstances, what will reconcile receding inflation and strengthening economic activity is the downward adjustment of expectations concerning future inflation and a change in behaviour based on these expectations. This adjustment in turn depends a lot on how strongly people believe that monetary policy will indeed hold to the path to price stability. The Bank of Canada attaches great importance to this fact.

As for Canada's recent inflation performance, 1991 began with high world oil prices and the introduction of the federal goods and services tax (GST). The headline rate of inflation – the 12-month increase in the consumer price index (CPI) – moved sharply higher, to almost 7 per cent, at the beginning of the year. And with the subsequent imposition of a variety of other indirect taxes by both federal and provincial governments, much doubt was expressed about the chances of any significant decline in inflation over the year. Not surprisingly, this scepticism extended to the first formal milestone of the inflation-reduction targets – that is, to get down to a 3 per cent pace of inflation by the end of 1992.

Views appear to have shifted a great deal in recent months. Indeed, now it is not uncommon to hear the reverse – that inflation has collapsed and that the Bank of Canada should claim victory.

I believe that a more measured assessment of developments is warranted.

In the first place, the issue is not, as is so often contended, one of "wars," "defeats" or "victories." The issue is the fundamental importance of having and maintaining a policy that provides monetary stability as a means to growth and productivity in our economy.

Furthermore, the pessimism of early 1991 was clearly overdone, and recent developments, while very positive, do not mean that inflation has disappeared. However, without a doubt, the steady decline in price inflation has had favourable effects on near-term inflationary expectations, as well as making the inflation-reduction targets that stretch beyond the near term more generally believable, and therefore more readily achievable. The fact that the economy was able to absorb the GST and the other indirect tax changes without provoking an inflationary spiral – a process of wages chasing prices, prices increasing further as a result, and so on – has been especially welcome. Certainly, the Bank of Canada has sought to make absolutely clear that monetary policy would not finance such a destructive process. The way that the price effects of the GST have been successfully absorbed has become even more widely recognized with the recent publication of the January 1992 CPI numbers.

In addition, a slowing in the upward trend of underlying costs of Canadian production has also begun, although, as is usually the case, this slowing has lagged behind the slowing in prices. Such an adjustment is important to secure progress to improved economic performance in Canada. It is a condition for improving the financial situation of businesses and providing a sound basis for expanding production and employment.

One important way in which eased concerns about inflation have shown up has been in the behaviour of long-term interest rates. Since their peak in the spring of 1990 these rates have fallen by over 2½ percentage points. The long-term rate differential between the United States and Canada has also declined appreciably over the period. In other words, savers and investors no longer demand as large an interest rate premium to protect themselves against inflation and other risks that could erode the value of their investments in Canada.

In summary, but without wishing to downplay the inevitable uncertainties ahead, we appear at this stage to be "on track" to achieving the inflation-reduction targets. This in turn holds the promise of a constructive, mutually reinforcing, process: achieving the initial target increases confidence that those further out will also be met. Such confidence provides a firm monetary foundation for lower interest rates, economic recovery and a sustained improvement in the performance of the Canadian economy. This monetary contribution cannot be a general guarantee, but it does matter a lot.

Recent Canadian monetary policy

From their peak in the spring of 1990 to the end of February 1992, short-term interest rates declined by over 6½ percentage points while long-term rates, as noted, declined by over 2½ percentage points. Borrowing and deposit rates at financial institutions have fallen similarly. This fall in interest rates across the spectrum has been nourished by the increased confidence of holders of Canadian dollar financial instruments (mostly Canadians) that the policy of reducing the rate of inflation will be successful. The drop in short-term rates since the peak in the spring of 1990 has been much greater than the decline in inflation.

The recent moderate growth of the various measures of money and credit has lent support to the view that the value of money in Canada will be maintained and, therefore, has contributed to the declines in interest rates. From annual rates of expansion of money and credit running in double digits two years ago, the pace has slowed significantly, with the broadly defined monetary aggregates increasing at between 6 and 8 per cent and private sector credit increasing at about 4 per cent.

Although the growth of the monetary aggregates has been reasonably well sustained, it tended for much of the past year to run at the lower end of the ranges for monetary expansion that we viewed as consistent, in the circumstances, with the contribution that monetary policy could responsibly make to the expansion of spending in the economy. This assessment of the performance of these aggregates, along with direct evidence on the development of spending in the economy and on inflation, encouraged the Bank in its actions to foster an easing of monetary conditions through 1991 and in the first months of 1992.

In putting its policy into effect, the Bank operates at the short-term end of the financial market, and its primary interest rate influence is felt at the very shortest end of that market. This involves influencing the rate on overnight financing in the money market through the quantity of settlement balances it makes available to the financial system. From time to time this basic cash balance technique is supplemented through sales or purchases of treasury bills. These operations, together with discussions of economic and financial developments, are chronicled throughout the year in the published minutes of the meetings of the Bank of Canada's Board of Directors.

Beyond the shortest end of the domestic financial market, interest rates are determined to a much greater degree by the expectations and decisions of savers and borrowers. Of course, in coming to their decisions, savers and borrowers take account of the thrust of monetary policy and what they believe other economic policies of governments are aiming to accomplish.

Indeed, what needs to be emphasized here is not the technical details of our operations, but that those operations take place in a market environment that the Bank cannot disregard or override. In other words, given the enormous size of the money market – Government of Canada treasury bills alone account for some $150 billion – the expectations of savers and borrowers matter enormously. Therefore, the common view that the Bank of Canada can set short-term market interest rates in some unilateral and arbitrary fashion without regard for the views and attitudes of savers and borrowers is totally unrealistic.

What the Bank of Canada can do if savers and borrowers have confidence that monetary policy will lead to lower inflation, and what the Bank was aiming to do during 1991 in light of the evolving financial and economic climate, is to manage down short-term interest rates in a progressive manner. In making judgments about the pace of interest rate decline, the Bank naturally was influenced in the latter part of 1991 by the signs of a renewed hesitation in the economy and by the growing evidence of an improvement in inflation and a lessening of concerns that inflation would persist in the future.

Participants in financial markets have ready access to a comprehensive range of economic and financial information. On this basis they can and do draw conclusions about the likely future developments in the market – including the course of action that the Bank of Canada might take.

We seek to pursue a steady course in our actions. Within this steady course, we have in the past year sometimes encouraged a faltering money market and on other occasions sought to temper a rush of market enthusiasm that might have provoked a decline of short-term interest rates too rapid to be sustained. Abrupt changes can themselves be counter-productive if they provoke uncertainty about our monetary policy intentions. At all times our guiding principle has been to act, and be seen to act, in a way that maintains confidence in the commitment of the Bank to the progressive achievement of price stability.

The Bank's actions do not have a direct impact on bond markets, but an important result of this policy approach has been the encouragement that it has provided for a pronounced downward movement of medium- and longer-term interest rates. If this seems an abstract point, it is worth noting that house mortgage rates are heavily influenced by interest rates in the bond market.

Although overall monetary conditions eased considerably in 1991 as a result of the sharp drop in interest rates, the external value of the Canadian dollar was buoyant through much of the year, both against the U.S. dollar and in terms of a broader measure that includes all major currencies. However, late in 1991 the Canadian dollar declined in value, closing at about the same level as a year earlier. In the first two months of 1992 the Canadian dollar declined further and, as one would expect, the weakening in the exchange market spilled over into the Canadian money market.

The exchange rate for the Canadian dollar is the net result of a range of forces, some domestic, some foreign. Here, however, it may be noted that confidence in Canadian policy played an important role in the foreign exchange market's valuation of the Canadian dollar, even though interest rate differentials declined significantly vis-à-vis all the major countries, including the United States. This confidence was apparent in strong demand by foreigners for Canadian dollar securities in both the domestic market and the Euro-Canadian dollar market. Indeed, non-resident borrowers themselves issued a substantial quantity of securities denominated in Canadian dollars, thereby taking advantage of the widening appetite around the world for investments in Canadian dollars in a market for financial assets that has become dramatically more global in recent years.

The external value of the Canadian dollar and where it fits in policy has continued to be a topic of much debate. Let me therefore make some comments on how the exchange rate fits into the Canadian monetary policy framework.

Over time, the basic factor underpinning the value of our currency in exchange markets is our ability to maintain the confidence that the domestic value of the Canadian dollar will not be eroded by inflation. As pointed out earlier, it is this domestic objective that is fundamental for Canadian monetary policy.

Accordingly, while the exchange rate plays an important role in the Canadian economy, it is not a basic target for monetary policy. Monetary policy is centrally about sustaining a pace of monetary expansion that is non-inflationary in order to preserve the integrity of money for Canadians.

But this does not mean that the Bank ignores the exchange rate when it initiates policy actions to affect monetary conditions. It takes careful account of movements in the exchange rate because such changes have important effects on aggregate demand and on prices. Furthermore, the Bank is always sensitive to the need to maintain through its actions confidence in the Canadian dollar in the event of financial disturbances.

* * * * *

The sluggishness in demand in the past year provides a good example of how developments in earlier periods can have lingering effects in the following years. The pile-up of deficits and debt during the 1980s is still being digested by the economic system and has inhibited its performance.

There is also plenty of evidence around the world of the wider damage done when monetary confidence is lost.

Fortunately, Canada does not need to share it. The investment of Canadian monetary policy in a stable monetary framework can now provide a fundamental basis for low interest rates as recovery proceeds. Of course, other things need to go right as well, but recognizing this does not prejudice the very real contribution that is being made by monetary confidence in supporting good economic performance.

ECONOMIC AND FINANCIAL DEVELOPMENTS

International environment

On the international front, economic activity in 1991 was inhibited by the after-effects from the excessive spending, inflation and debt accumulation of the latter half of the 1980s. In some countries the recovery from recession has been sluggish, while other countries have experienced a slowing from unsustainably high rates of expansion. The softer economic environment contributed to a decline in world commodity prices.

Economic activity and inflation

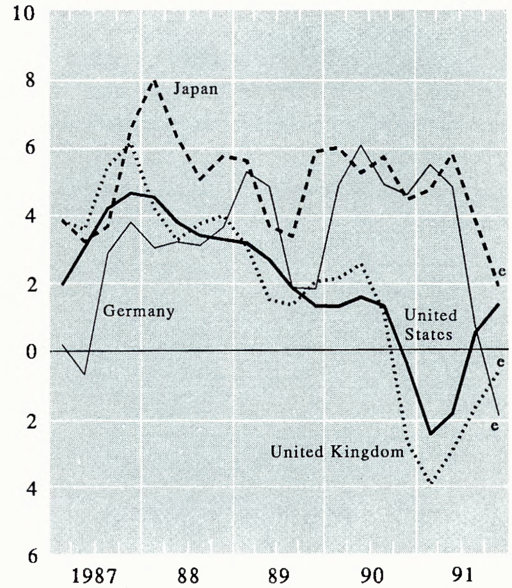
Those foreign economies that were subject to the strongest demand and inflationary pressures during the latter half of the 1980s, such as the United States and the United Kingdom, were among the first to tighten monetary conditions. However, pressures that had built up over this period were not easily reduced, and these countries experienced a significant slowing in the growth of domestic demand.

The "soft landing" that had been hoped for in the United States and the United Kingdom actually turned into recession in the second half of 1990, in part because of unforeseen international events such as the Iraqi invasion of Kuwait and the related volatile movements in oil prices, as well as the associated sharp declines in consumer and business confidence.

The United States and the United Kingdom were still in recession at the start of 1991. As the year progressed, there were few signs of recovery in the United Kingdom, whereas the United States recorded positive, if very modest, rates of expansion. Heavy debt servicing requirements, combined with other factors such as declining real estate prices and relatively low levels of consumer and investor confidence, have contributed to the sluggishness of the recovery.

Output in selected major industrial countries

Two quarters over previous two quarters, percentage change at annual rates, quarterly data, seasonally adjusted



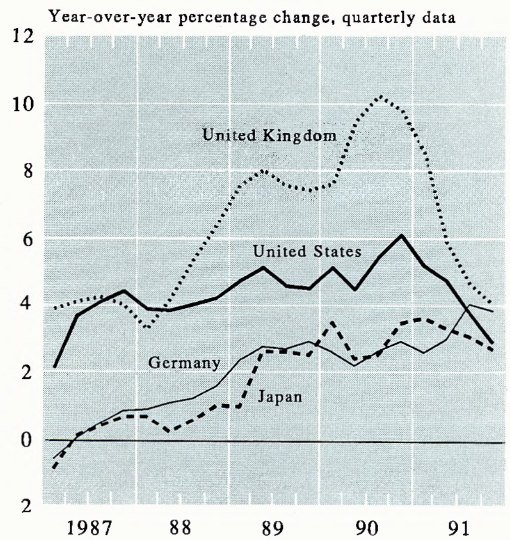
ᵉ Estimate

Germany and Japan, whose rapidly expanding economies had provided an impetus to demand in other countries through 1989 and 1990, began to experience a slowing in the pace of activity in 1991. In Japan, there was some reversal of the earlier speculative run-up in real estate and stock market prices in response to firmer monetary conditions. And those Japanese financial institutions with a significant portion of their assets either backed by or invested directly in real estate and the stock market entered a period of consolidation after many years of rapid credit expansion.

During 1990, the German economy operated at unsustainable levels of activity, driven in part by large budget deficits associated with unification as western Germany transferred large sums to eastern Germany. As inflationary pressures mounted, monetary conditions tightened, with the result that the pace of economic expansion moderated through 1991. The economic and political uncertainty that surrounded events in Eastern Europe and the former Soviet Union, and the higher taxes that were introduced mid-way through the year to finance the transfers to eastern Germany, also contributed to the moderation.

In 1991, inflation pressures eased in the United States and all the major overseas economies, with the exception of Germany where the level of demand remained high relative to available supply through the year.

Consumer prices

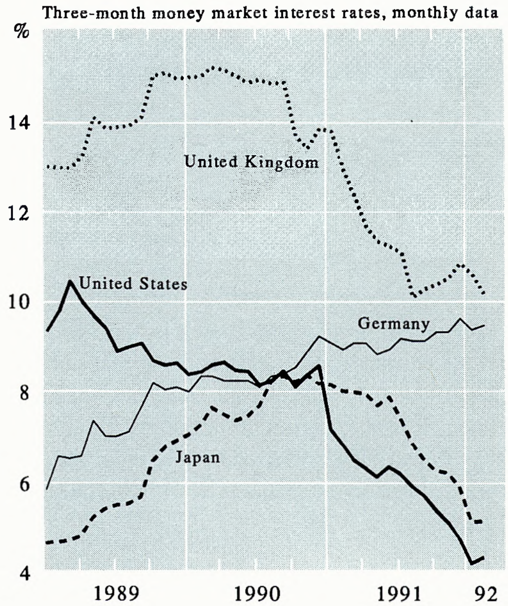


Interest rates and exchange rates

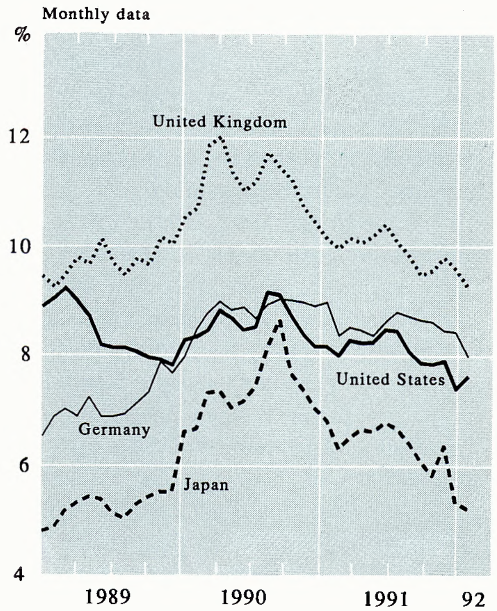
Through 1991, the marked easing of demand pressures and the improvement in inflation in most countries provided scope for lower short-term interest rates.

Substantial declines in short-term interest rates were recorded in the United States, the United Kingdom and Japan. In contrast, short-term interest rates rose in Germany as demand and inflationary pressures persisted. In all countries, however, the anti-inflationary stance of policies contributed to a decline in long-term rates.

Short-term interest rates in selected major industrial countries

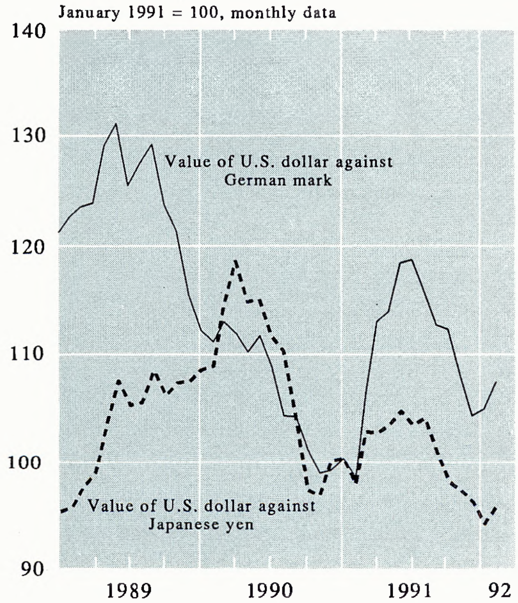


Long-term interest rates in selected major industrial countries



Movements in exchange rates over the year reflected changing interest rate differentials as well as a number of other economic and political factors. The U.S. dollar depreciated sharply against the major overseas currencies in the second half of 1990 and remained at low levels in early 1991 in response to weak domestic demand, declining U.S. interest rates and uncertainty surrounding developments in the Middle East. Though the dollar rebounded through mid-1991 on a temporary resurgence of consumer and investor confidence following the Gulf War, it subsequently declined again as the post-war mood dissipated, economic activity in the United States appeared to stall, and there was a further significant easing in U.S. interest rates.

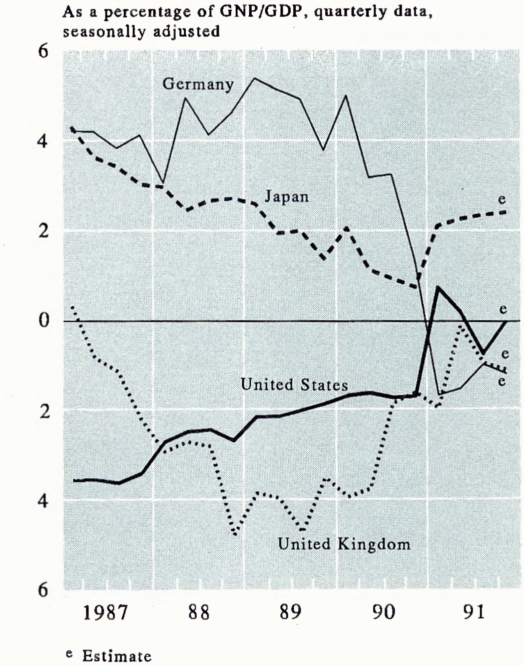
U.S. dollar against selected foreign currencies



International trade and payments

External imbalances across many of the major industrial countries declined further in 1991 and are now significantly lower than the record levels reported in the mid- and late 1980s. Though much of the improvement in 1991 reflected changes in underlying economic conditions and exchange rate movements, some of it was due to temporary factors – among these, the large transfer payments received by the United States from Germany and Japan after the Gulf War.

Current account balances



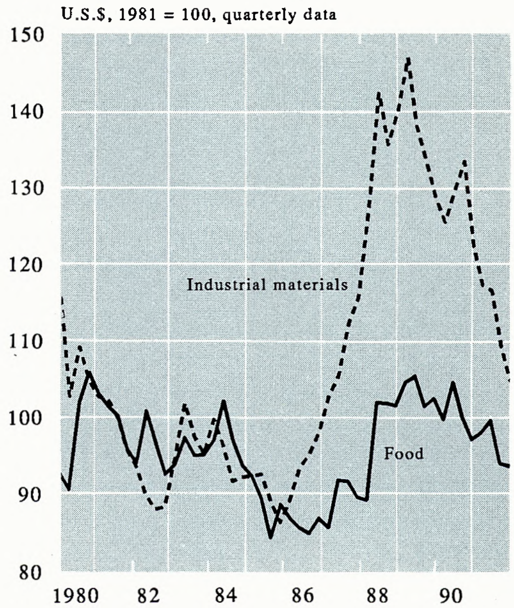
In 1991 trade frictions reemerged as an important concern. Disputes between Japan, Europe and the United States have attracted increased attention in recent months, raising concerns about renewed protectionism and the emergence of restrictions on international trade flows. These disputes have also impeded progress on the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). These multilateral negotiations are of particular importance to Canada, which is highly dependent on world trade in both manufactured and primary products.

World commodity prices

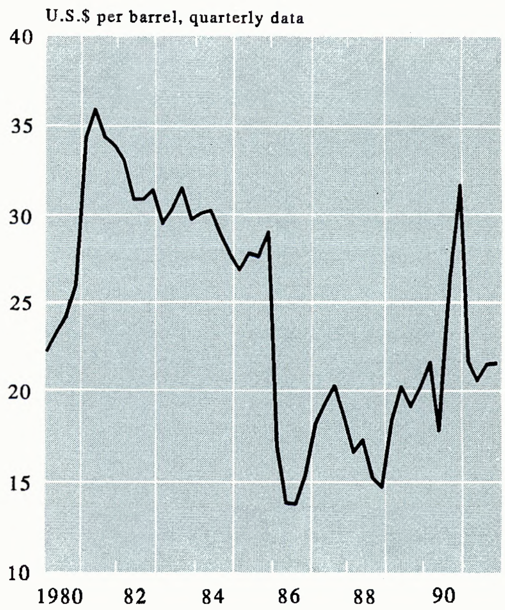
Sluggishness in industrial production in the major world economies and additions to productive capacity in commodity exporting countries led to further declines in world commodity prices in 1991. In U.S. dollar terms, the average price of commodities produced in Canada fell to its lowest level in four years.

General commodity price index

Food and industrial materials prices



World oil prices



Prices of industrial materials and many food products were affected as well by rising inventories and, in the case of certain metals, a sharp increase in exports from the former Soviet Union as authorities tried to replenish their foreign exchange reserves. A notable exception in this regard was the price of wheat, which rose through most of the year in response to declining world stocks and increased import demand from the former Soviet Union.

Following the sharp upward movement and subsequent reversal of crude oil prices surrounding the events in the Persian Gulf, world oil prices remained relatively unchanged through most of 1991. Withdrawal of Kuwaiti and Iraqi supplies from oil markets and a marked decline in production in the former Soviet Union were largely offset by increased production in Saudi Arabia and reduced demand in North America.

Domestic economic activity and inflation

Total dollar spending continued to grow slowly in 1991, while inflation declined. The moderation in inflation and subsequent easing in monetary conditions have provided the basis for recovery from recession. Nonetheless, the consequences of past inflationary behaviour, such as rising costs and indebtedness as well as over-investment in certain sectors, continued to exercise a moderating influence on domestic demand, while the sluggishness of activity in the United States and the slowdown in the overseas economies dampened foreign demand. Weakness in world prices for commodities also had the effect of slowing the growth of real income and demand in Canada.

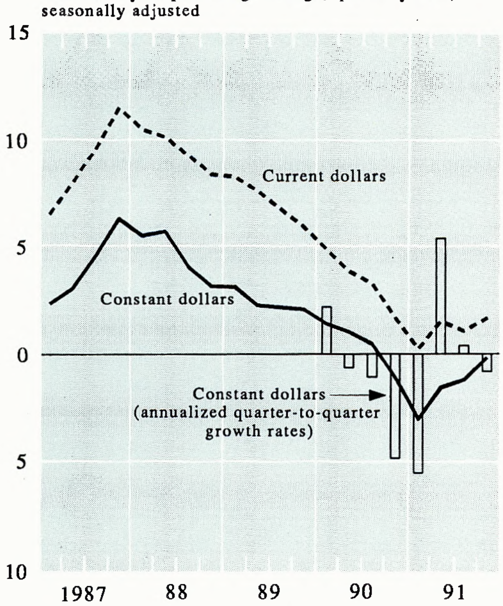
Aggregate demand

The economic slowdown continued into the first quarter of 1991, amid disturbances arising from unstable oil prices, the decline in demand in the United States and the realignment of relative prices in Canada resulting from federal sales tax reform. The Canadian economy rebounded sharply in the second quarter, but there was virtually no growth in the remainder of the year.

After posting a strong recovery in the second and third quarters of the year, Canadian exports in volume terms fell in the last quarter, mainly reflecting the sluggishness of the U.S. recovery, particularly the weakness in the

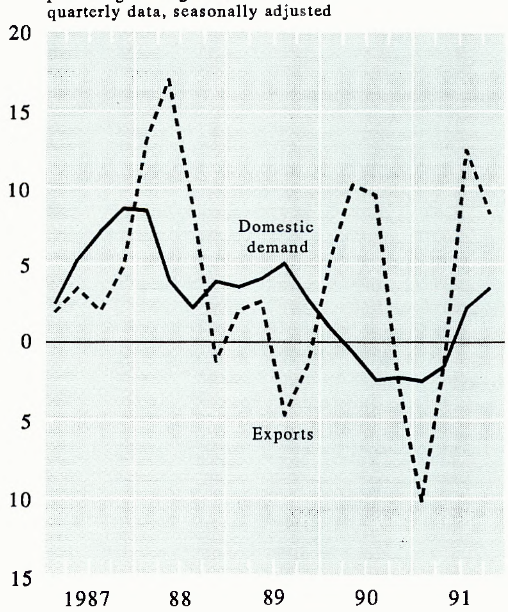
Gross domestic product

Year-over-year percentage change, quarterly data, seasonally adjusted



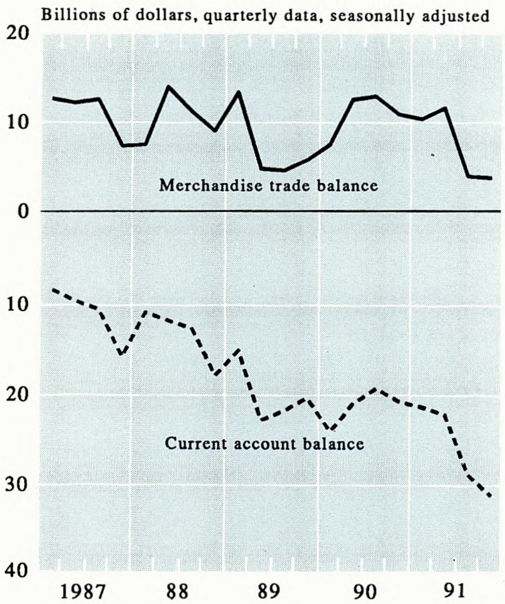
Domestic demand and exports, constant dollars

Two quarters over previous two quarters, percentage change at annual rates, quarterly data, seasonally adjusted



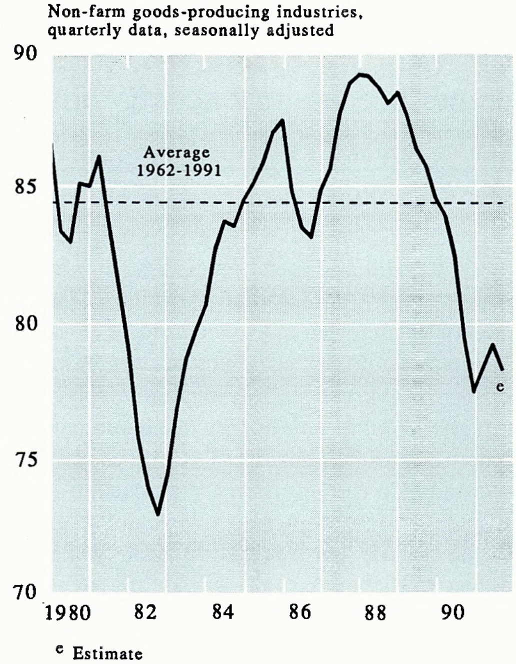
automobile sector. As noted earlier, export revenues and consequently national income were adversely affected by the weakness in world commodity prices. While the strength of the Canadian dollar undoubtedly accentuated the decline in export prices in Canadian dollars, it also contributed to the decline in import prices, thereby moderating the deterioration in the terms of trade. However, the fall in import prices was also a factor in the rise in imports at the expense of Canadian-made products. In this context, the Canadian trade surplus declined sharply and the current account deficit for the year grew by almost $5 billion.

Balance of payments



Investment spending increased substantially in the energy sector, particularly in utilities and pipeline construction. However, shrinking profit margins and the generally high level of excess capacity led businesses in non-energy sectors to reduce investment further. This was most noticeable in commercial real estate, where rapid growth in recent years had produced

Rate of capacity utilization



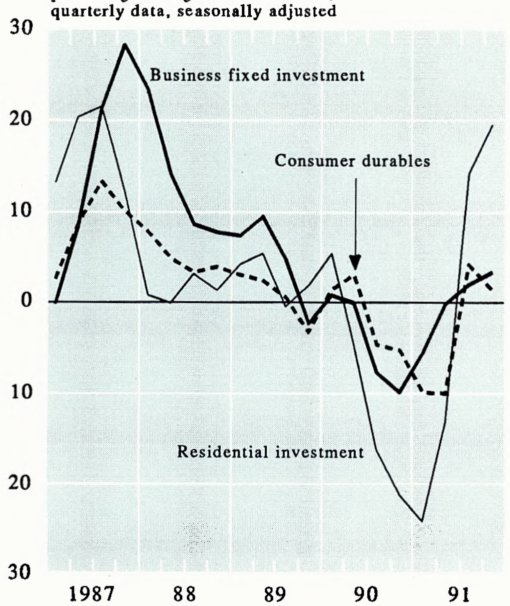
a sizeable surplus that has not yet been absorbed. Nevertheless, the fall in interest rates, by reducing the cost of capital and easing the debt service of businesses, has created a climate conducive to an investment recovery.

The efforts of most governments in Canada to contain their budget deficits, notably through tax measures which reduced the real disposable incomes of households, played a part in restraining the growth of aggregate demand.

Faced with high levels of debt and a less favourable employment situation, households reacted to the decline in their real disposable income by reducing their consumption spending. This development, coupled with the increasing trend towards cross-border shopping, resulted in an especially pronounced drop in retail sales. However, the combination of the decline in interest rates, the fall in house prices and government support programs for housing has sparked a significant recovery in the demand for housing. As discussed in the next section, the decline in interest rates and the slowing in the growth of household indebtedness have also reversed the upward trend in the debt service

Indicators of household and business demand, constant dollars

Two quarters over previous two quarters, percentage change at annual rates, quarterly data, seasonally adjusted



costs of households, thereby lessening the restraining influence of this factor on the growth of consumer spending.

The sluggishness of the economy resulted in a further drop in employment. The unemployment rate stood at 10.3 per cent at the end of the year, an increase of 1 percentage point compared to a year earlier.

Regional activity

The weakness of economic activity was most pronounced in Ontario. In part this reflected a correction from the unsustainable level of demand experienced during the 1988-89 period, which had led to a rapid escalation of costs in Ontario and an overhang of commercial real estate. The relatively large reduction in spending on automotive products in North America and in the demand for durable goods generally also had a disproportionate influence on Ontario, where the production of durable manufactured goods is particularly important. The decrease in economic activity, along with the growing penetration of imports, eroded the profitability of the manufacturing sector and led to a substantial decline in employment in the province. The latter contributed in turn to a larger reduction in retail sales in Ontario than in any other region.

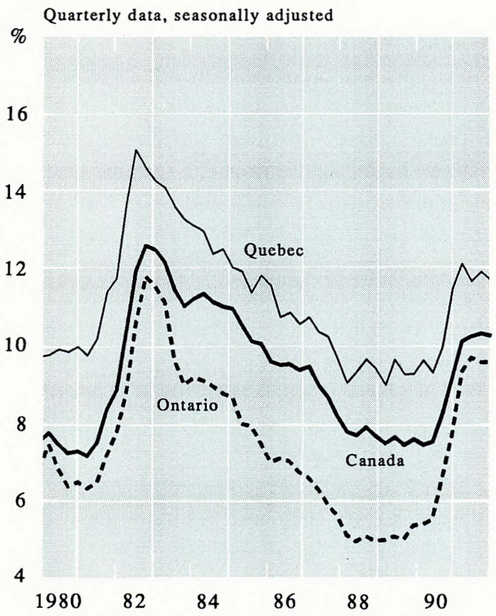
The Quebec economy also experienced a contraction as foreign demand slowed, the prices of forest products, primary metals and chemicals fell, and the broadening of the Quebec sales tax dampened consumer spending. However, a substantial increase in investment in the electric power industry and the stimulation of residential construction by a provincial government program provided some support to economic activity.

Considerable difficulties in the resource industries weakened the economies of Atlantic Canada, with price declines occurring in key commodities such as metals, forest products and potatoes. Lower fish landings more than offset the impact of higher cod prices. However, non-residential construction increased as a result of important electric power projects and site preparation work for the Hibernia project.

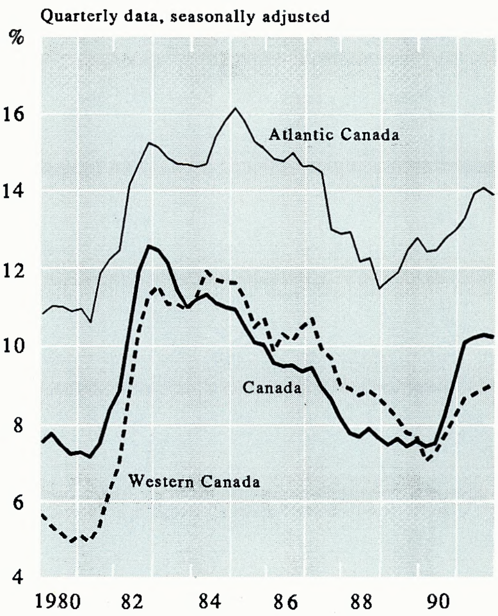
In the Prairies a decline in the average price of grain received by farmers from the Canadian Wheat Board contributed to a decrease in farm incomes to still lower levels despite a bumper harvest. Lower prices for crude oil, natural gas and petrochemicals also contributed to employment cuts in the petroleum industry. While emigration further restrained consumption and housing demand in Manitoba and Saskatchewan, activity was relatively firm in Alberta due in part to immigration, higher export volumes of energy and the continuation of large investment projects related to natural gas, pulp and paper, and chemicals. Reflecting this relative buoyancy, employment in Alberta rose by 1 per cent during the year.

While also facing lower commodity prices in key areas such as metals and pulp, employment in British Columbia nevertheless expanded by over 2 per cent during the year, with strong gains in transportation and utilities, manufacturing, and finance, insurance and real estate. Construction activity was buoyed by work on commercial projects in Vancouver and Victoria. Continued immigration from the rest of Canada and from abroad further helped support demand, with retail sales falling much less than in the other regions.

Unemployment rate



Unemployment rate

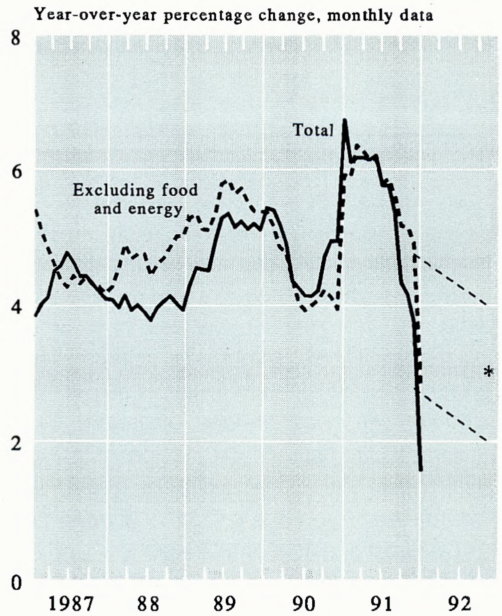


Price and cost developments

The slowing in the pace of total spending was reflected in a significant reduction in the underlying rate of inflation, which occurred in spite of the fact that the introduction of the GST and increases in other indirect taxes added about 2.4 percentage points to the consumer price index during the year.

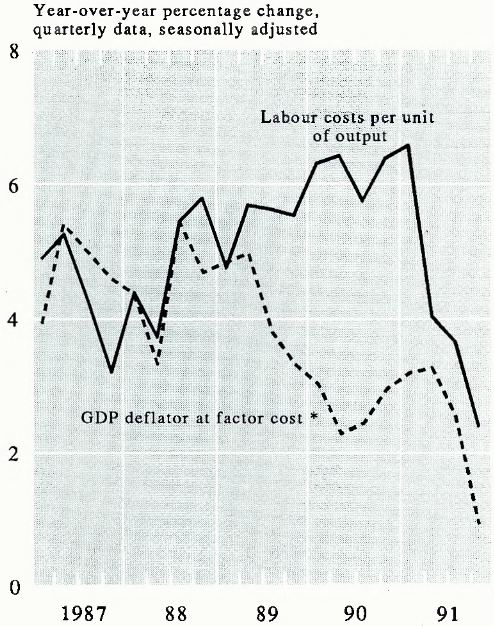
After rising to 6.8 per cent following the introduction of the GST, the 12-month increase in the CPI fell to 3.8 per cent in December. This decline reflected in part the reversal of the temporary rise in oil prices at the time of the Persian Gulf crisis. In January 1992, the rate of increase in the CPI fell to 1.6 per cent as the direct effects of the GST dropped out of the year-over-year growth rate. The decline in the rate of increase in the CPI, excluding food and energy, was also significant, although less dramatic. Following a sharp increase attributable mainly to higher indirect taxes, the rate of increase of this index gradually declined to 5 per cent in December, and then to 2.9 per cent in January 1992.

Consumer price index



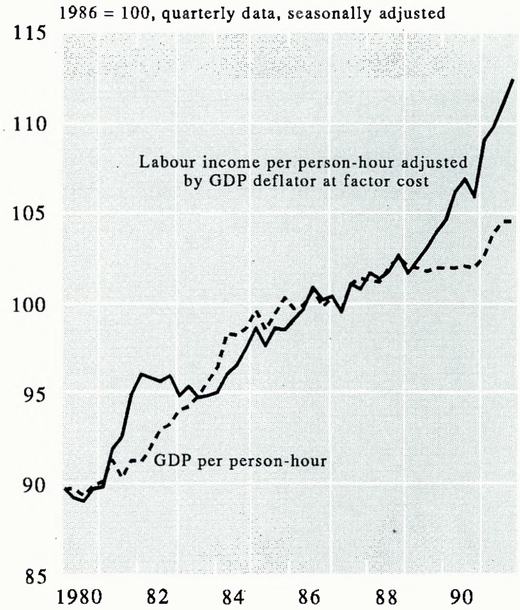
* Inflation-reduction target
-- Band

Unit labour costs and GDP deflator at factor cost



* Excluding federal sales tax rebate on inventories in the fourth quarter of 1990.

Real wages and labour productivity



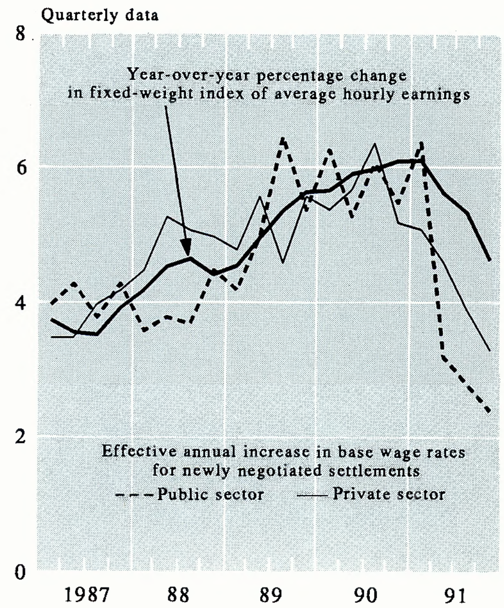
The upward trend in production costs began to moderate in 1991, although the growth of wages was slow to respond to the easing of demand. While the growth rate of the GDP deflator at factor cost – the broadest indicator of Canadian producer prices – remained on average around 2.5 per cent for a second year in a row, growth in average hourly earnings continued at over 5 per cent for almost the entire year. The rise in productivity contributed to a deceleration in the growth of unit labour costs, but it did not compensate fully for the gap between the increase in wages and that in producer prices. The resulting divergence between productivity and real wages led to a further narrowing of profit margins.

While negotiated wage increases in major settlements decelerated more rapidly than the growth in average earnings, these settlements, particularly in the private sector,

Corporate profits

were also slow to reflect changing labour market conditions and the decline in inflation. Towards the end of the year, however, private sector wage settlements dropped below 3½ per cent. The wage restraint programs introduced by the federal government and most provinces hastened the adjustment of wages in the public sector, and this contributed significantly to the deceleration of cost increases in Canada.

Wage costs



Domestic monetary and financial developments

Monetary aggregates and credit market developments

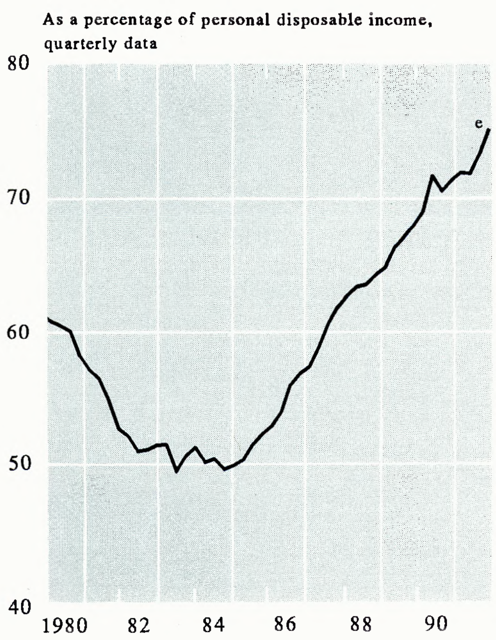
After growing rapidly in the late 1980s, the broad monetary aggregates slowed markedly in 1990 and slowed still further in 1991. The deceleration in growth reflected easing inflationary pressures and the slowing in the pace of economic activity. In 1991, M2 rose by 6 per cent and M2+ by 8 per cent, both 2 percentage points lower than in 1990.

The narrow monetary aggregate M1 actually fell in 1990 but rose by 4 per cent in 1991. The turnaround in M1 can be attributed mainly to the sizable declines in interest rates, although the growth of M1 in 1991 was less than would have been suggested by historical relationships.[1]

The growth of total household credit slowed to 6 per cent in 1991 in spite of lower interest rates. High levels of existing debt, increased uncertainty about future income growth, and expectations of lower future house price increases in a less inflationary environment all helped explain this moderation. While the ratio of household indebtedness to personal

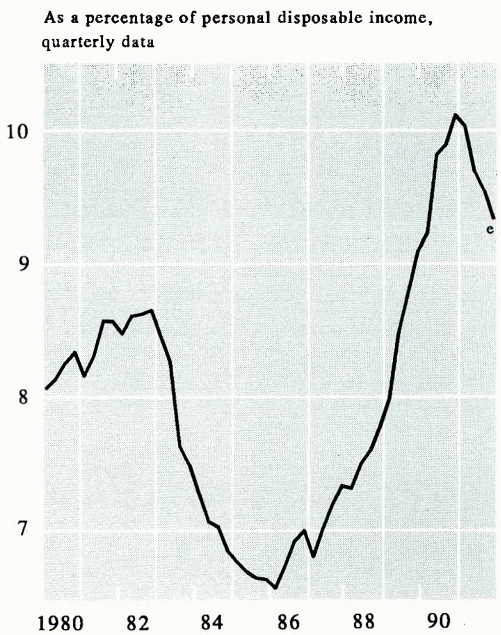
[1] See "Recent developments in Canadian monetary aggregates," *Bank of Canada Review*, January 1992.

Household credit [1]



1. All lending institutions
e Estimate

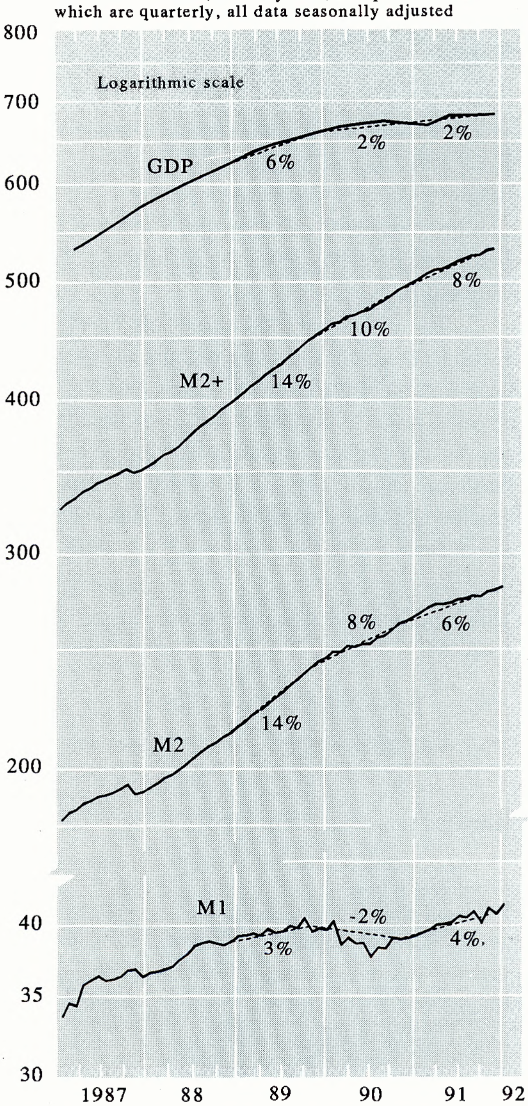
Estimated household debt service



e Estimate

Monetary aggregates and gross domestic product (GDP)

Billions of dollars, monthly data, except GDP data which are quarterly, all data seasonally adjusted



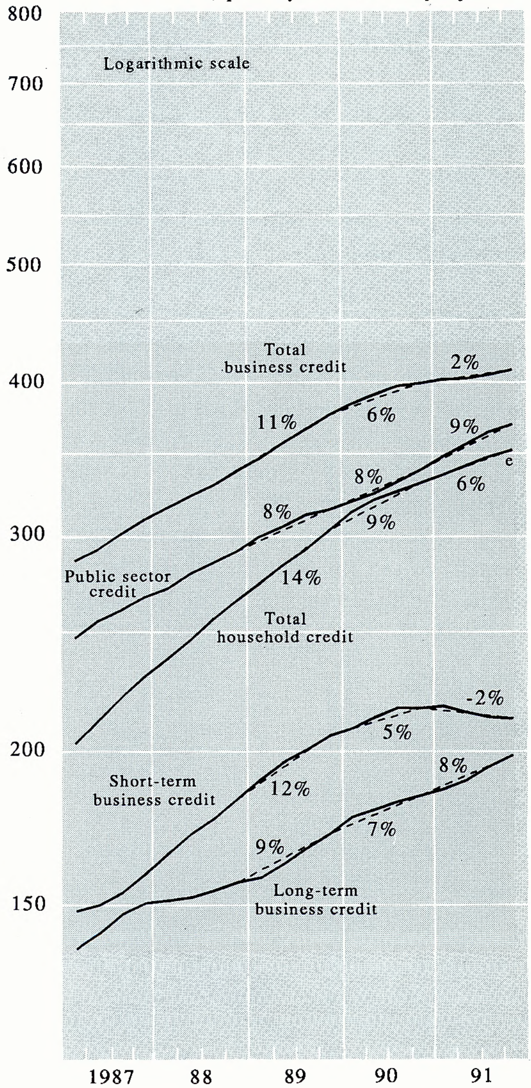
M2+:
M2 plus deposits at trust and mortgage loan companies, deposits and shares at credit unions and caisses populaires, deposits at Province of Ontario Savings Office and Alberta Treasury Branches, holdings of money market mutual funds and annuities issued to individuals.

M2:
M1 plus personal savings deposits and non-personal notice deposits.

M1:
Currency and demand deposits less private sector float.

Credit aggregates

Billions of dollars, quarterly data, seasonally adjusted



Total business credit:
Short-term business credit plus long-term business credit.

Short-term business credit:
Loans and financial leases extended to, and acceptances and commercial paper issued by, non-financial businesses. Foreign currency loans are adjusted to exclude the effect of exchange rate movements.

Long-term business credit:
Bonds and equities issued by non-financial businesses.

Total household credit:
Consumer credit and residential mortgage loans.

Public sector credit:
Loans extended to, and bonds and bills issued by, federal, provincial and municipal governments, and guaranteed bonds issued by provincial and municipal government enterprises.

e Estimate for total household credit in fourth quarter.

Note: All growth rates are calculated as the rate of change on a fourth-quarter-over-fourth-quarter basis.

disposable income rose further in 1991, the debt service ratio for households declined as interest rates fell through the year. This reduction in the debt service ratio implies an increase in discretionary income in 1992.

Total business credit grew by 2 per cent in 1991, down from 6 per cent in 1990. The slowing in the demand for credit reflected the cutback in investment spending and the decline in liquid asset holdings in response to sluggish output growth and low profits. There was also a significant shift in the composition of credit as businesses attempted to improve their balance sheets by shifting towards equity and longer-term bond financing. Short-term business credit, in contrast, declined by 2 per cent overall and by 3 per cent at banks.

Corporate debt-to-equity ratio

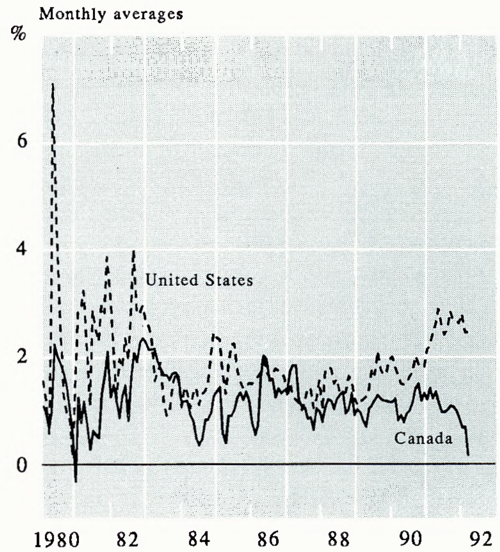
e Estimate

During 1991 there was much discussion in the United States of a "credit crunch." This term has been used to describe a situation in which low growth of bank credit, especially to business, reflected an unusual reluctance on the part of banks to lend. In Canada, it does not appear that the weakness in credit at banks was due to a significant change in overall lending behaviour. Rather, the dominant factor was the weakness in the demand for total business credit, along with the shift in its composition towards equity and long-term debt.

Nevertheless, there are indications that financial institutions have been exercising caution in extending credit to certain sectors, consistent with prudent lending practice, given the current state of the economy and recent loan-loss experience. In particular, financial intermediaries were concerned about loans for commercial real estate, given the rise in vacancy rates and the declines in property values and rents.

Movements in interest rate spreads support the view that, overall, Canadian banks have been approaching their lending decisions in a manner consistent with past practices. Spreads between the prime rate and short-term market interest rates actually narrowed significantly over the last year and a half to some 70 basis points at year-end, well below the recent historical average of 120 basis points. In contrast, such spreads widened considerably in the United States.

Differential between prime rate and 90-day commercial paper

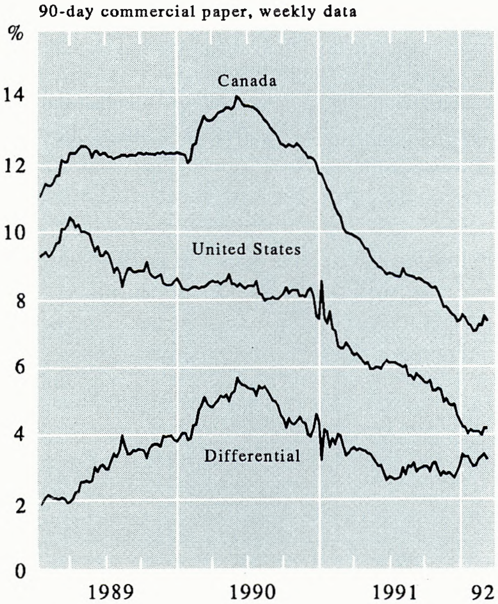


Monetary conditions

Monetary conditions eased significantly in 1991 and early 1992.

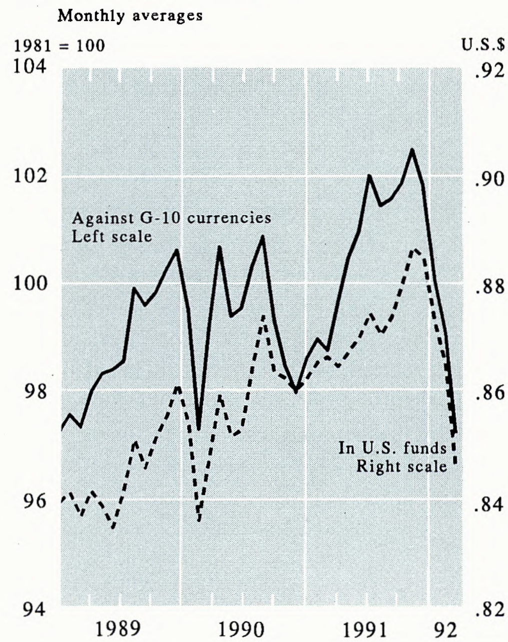
Short-term interest rates fell sharply in 1991, with 90-day paper rates declining from about 11½ per cent at the start of the year to 7½ per cent at year-end. While these rates fluctuated in the first two months of 1992, on balance they edged down further.

Canada-U.S. short-term interest rates



During the first ten months of the year the Canadian dollar on a trade-weighted basis rose by 4¼ per cent despite the decline in interest rate differentials against all major industrial countries. Underpinning the currency was strong demand for Canadian dollar assets, reflecting investor confidence in the commitment of Canadian monetary policy to its medium-term objective of price stability. In the latter part of 1991 the slowdown in capital inflows, stemming in large part from the further declines in interest rate differentials vis-à-vis the major European countries, contributed to the somewhat weaker dollar. At year-end the Canadian dollar was trading at about the same level as it began the year. The further decline in the Canadian dollar that began in mid-January 1992 brought the currency to a range of 84 to 85 cents (U.S.) during February.

Canadian dollar exchange rate

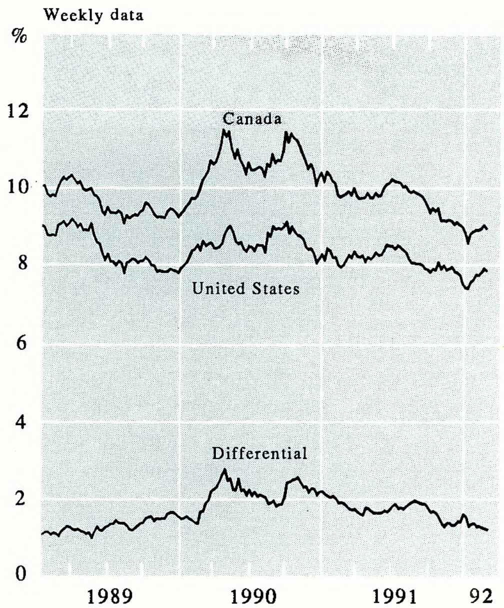


As inflationary expectations were revised downward, Canadian long-term bond yields declined substantially. Administered rates generally came down in line with market rates for similar maturities, and chartered banks lowered their prime rate on business loans by 4¾ percentage points during the year to 8 per cent. Mortgage rate declines were also pronounced, with one-year rates falling by 4 percentage points to 8½ per cent and 5-year rates by 2½ percentage points to just under 10 per cent by the end of 1991. Administered rates declined further in January 1992. The prime lending rate fell to 7½ per cent and the 5-year mortgage rate to 9¾ per cent – the lowest rates in nearly 20 years.

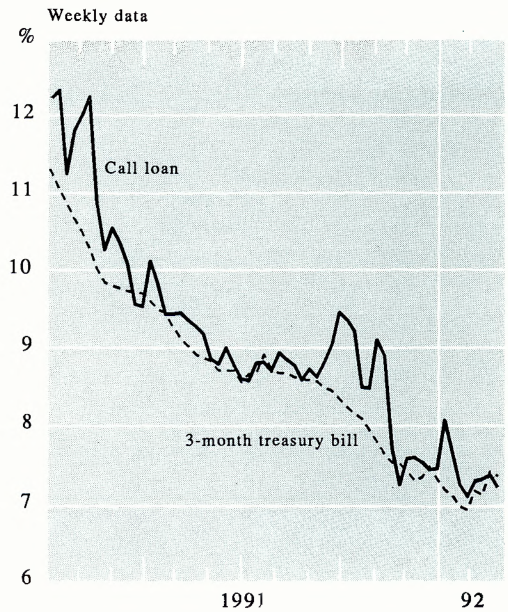
Monetary policy operations

For much of 1991 market expectations of declines in short-term interest rates were sufficiently strong that the Bank, in order to prevent unsustainably rapid reductions in rates, acted to temper the pace of such movements. The main method used was to limit the total supply of settlement balances that the directly clearing members of the Canadian Payments Association (CPA) maintain at the Bank of

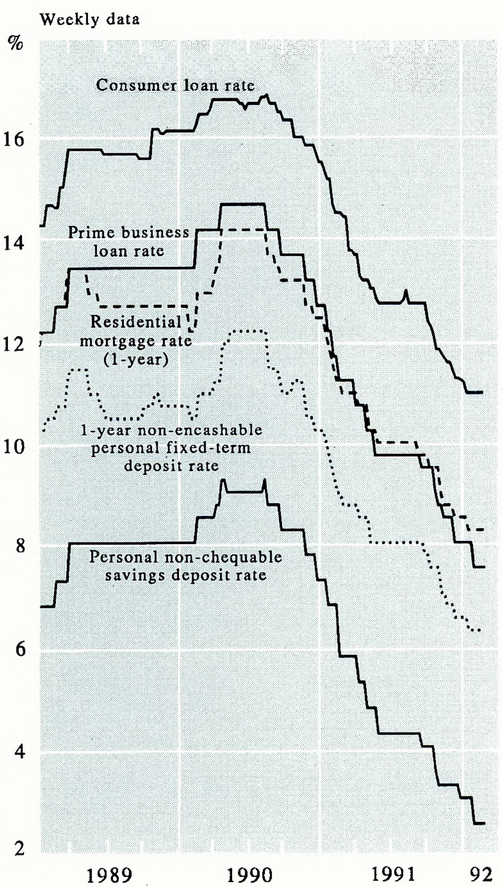
Yields on long-term Canadian and U.S. government bonds



Call loan and 3-month treasury bill rates



Selected bank interest rates



Canada, relative to the amount they were seeking to hold. This action put upward pressure on the overnight cost of financing investment dealers' inventories of money market instruments, with the call loan rate usually above the 3-month treasury bill rate. The Bank at times also took action through open market operations to restrain excessively rapid declines in short-term rates. It frequently sold treasury bills into the market and occasionally moved to tighten overnight financing through Sale and Repurchase Agreements (SRA). SRA involves offering to sell Government of Canada securities to chartered banks at a rate of the Bank's choosing and to buy them back the next business day.

On those occasions when overnight rates were higher than intended and the treasury bill market weakened, the Bank eased the cost of financing by offering, at a rate of its own choosing, Special Purchase and Resale Agreements (SPRA) to designated investment dealers and chartered banks (the jobbers). This involved buying short-term Government of Canada securities (typically treasury bills) and selling them back to the jobbers the next business day. The Bank also occasionally bought treasury bills outright in the market. The details of these various transactions are shown in Table 1.

Table 1
Bank of Canada transactions

Millions of dollars unless otherwise indicated

		Sale and repurchase agreements (SRA) outstanding		Special purchase and resale agreements (SPRA) outstanding		Purchase and resale agreements (PRA)[1] outstanding		Sales and purchases of treasury bills[2]	
		Number of days	Average[3] amount	Number of days	Average[3] amount	Number of days	Average[3] amount	Sales	Purchases
1991									
January	**1–15**	0	0.0	0	0.0	9	363.4	4,315.0	98.0
	16–31	0	0.0	1	37.9	10	303.6		
February	**1–15**	0	0.0	4	180.9	11	350.0	1,735.0	470.0
	16–28	0	0.0	3	137.8	8	362.6		
March	**1–15**	0	0.0	6	270.5	10	336.4	1,932.7	687.7
	16–31	0	0.0	1	20.6	6	136.6		
April	**1–15**	1	4.5	1	40.5	5	128.2	3,419.0	339.0
	16–30	0	0.0	2	69.5	5	78.3		
May	**1–15**	1	34.1	0	0.0	9	174.6	2,907.0	–
	16–31	0	0.0	0	0.0	7	103.8		
June	**1–15**	0	0.0	1	32.0	6	105.4	1,653.1	433.1
	16–30	0	0.0	0	0.0	4	103.2		
July	**1–15**	0	0.0	1	102.5	3	46.2	2,287.6	1,732.6
	16–31	3	67.9	1	26.7	3	27.1		
August	**1–15**	0	0.0	0	0.0	6	130.7	2,095.0	100.0
	16–31	0	0.0	0	0.0	5	117.9		
September	**1–15**	0	0.0	2	106.1	4	63.2	3,504.0	360.0
	16–30	0	0.0	1	37.3	10	319.2		
October	**1–15**	0	0.0	5	220.5	9	290.7	2,460.0	130.0
	16–31	0	0.0	2	105.0	11	303.1		
November	**1–15**	0	0.0	3	297.5	8	259.9	1,285.0	123.0
	16–30	0	0.0	1	43.5	1	21.5		
December	**1–15**	0	0.0	0	0.0	8	222.8	2,522.6	962.6
	16–31	1	77.5	3	164.0	2	9.4		
1992									
January	**1–15**	1	25.0	2	59.5	9	240.0	2,363.0	321.0
	16–31	0	0.0	1	33.8	5	81.5		
February	**1–15**	0	0.0	1	42.0	4	37.7		

1. Ordinary PRA is a form of financing available to investment dealer jobbers at their initiative, at Bank Rate and up to a predetermined limit.
2. Excludes purchases at tender and sales to client accounts. Includes portfolio-related switches of bills with money market participants.
3. Average based on the number of clearing days.

Cash reserves, settlement balances and advances

Millions of dollars unless otherwise indicated

Chartered bank cash reserves			Directly clearing non-bank members of the Canadian Payments Association		
Cumulative excess reserves at end of period	Advances to chartered banks outstanding: Number of days	Advances to chartered banks outstanding: Average[3] amount	Average deposit at Bank of Canada	Advances to non-banks outstanding: Number of days	Advances to non-banks outstanding: Average[3] amount
1,088	10	142.7	67	18	13.9
334	12	79.6			
1,555	11	145.4	81	12	31.7
818	9	148.4			
1,426	11	76.6	80	13	19.5
2,425	9	64.1			
616	11	100.0	66	19	19.9
759	11	88.4			
253	11	117.9	67	15	17.8
1,234	11	116.7			
1,044	10	68.7	61	16	27.4
1,928	10	55.4			
951	10	120.8	79	14	10.2
198	12	82.1			
319	11	142.9	70	16	10.3
2,133	11	89.3			
1,214	9	102.3	61	14	13.2
952	11	192.5			
1,718	10	118.6	70	15	15.2
2,314	12	43.1			
1,848	10	98.8	59	19	33.8
3,063	10	162.7			
1,594	10	193.4	63	20	52.5
1,638	10	190.6			
1,619	10	151.1	59	21	56.4
2,508	12	161.0			
931	10	209.5			

Cumulative computed settlement balances of bank and non-bank direct clearers	
Nov. 18 – Dec. 15	2,077
Dec. 16 – Jan. 15	625
Jan. 16 – Feb. 16	465

The framework linking the Bank of Canada to directly clearing financial institutions was modified as of 18 November 1991 to take account of changes impending under new financial institutions legislation (see below). One feature of the new system will be an increase in the number of advances that these financial institutions can be expected to take from the Bank of Canada. Table 1 shows the chartered banks' average excess reserve position for each reserve-averaging period in 1991, as well as the average monthly settlement balances for other direct clearers as a group. It also shows, from 18 November, the cumulative settlement balances of the direct clearers for each of the new averaging periods. In addition, the table reports the average advances outstanding. For banks these include $29.5 million of extraordinary advances outstanding on 31 December 1991 to the Canadian Commercial Bank and the Northland Bank, the amount remaining of the advances made to these two banks in 1985.

* * * * *

Financial institutions legislation

The federal government's legislation on financial institutions, consisting of four bills covering banks, trust and loan companies, insurance companies, and co-operative credit institutions, received royal assent in December and is expected to be proclaimed in the spring of 1992. Under the legislation, federally regulated financial institutions will be able to offer most financial services either directly or indirectly through subsidiaries or networking. There will be certain exceptions, such as the restrictions against selling insurance through the branches of deposit-taking institutions. The changes will result in increased competition, thereby offering households and firms a greater choice of suppliers of financial services and products, as well as increased convenience. A provision in the legislation requires it to be reviewed in five years.

The legislation maintains widely held ownership requirements for Schedule I banks and imposes a requirement (with the possibility of ministerial exemptions) that at least 35 per cent of the voting shares of other financial institutions with over $750 million in equity be widely held. The Minister of Finance must approve all significant ownership changes.

A number of measures have been introduced to improve prudential safeguards. First, transactions of regulated financial institutions with related parties have been banned, with certain exceptions. Second, the Office of the Superintendent of Financial Institutions will have the power to obtain information from upstream companies or affiliates of regulated financial institutions. Finally, the role of boards of directors of financial institutions has been strengthened.

Of particular relevance for the way monetary policy is implemented is the elimination of legislated reserve requirements for chartered banks. Secondary reserve requirements will be eliminated immediately upon proclamation of the legislation, while primary reserve requirements will be phased out over a two-year period. In response both to this legislated phase-out and to the declines in required reserve deposits that have occurred in recent years, on 18 November 1991 the Bank of Canada changed the framework for implementing monetary policy on a day-to-day basis as outlined in Discussion Paper No. 3.[2] The new system will permit the Bank to exercise a degree of influence over very short-term interest rates similar to that under the previous system.

2 *The Implementation of Monetary Policy in a System with Zero Reserve Requirements*, Discussion Paper No. 3, revised September 1991.

BANK OF CANADA ACTIVITIES

The Bank of Canada's activities relate to the four major functions set out in the *Bank of Canada Act*: monetary policy formulation; banking activities; the issue of bank notes; and management of Government of Canada debt.

Monetary policy formulation

In the area of monetary policy, the responsibility of the Bank of Canada is to contribute to good general economic performance in Canada. As discussed in the General Observations section of this report, this means managing the rate of monetary expansion in a way that is consistent with ensuring that the value of money is not eroded by persistent inflation. To this end, in February 1991 the Bank of Canada and the Government of Canada jointly announced targets for reducing inflation in Canada. The specific targets are to reduce the year-over-year rate of increase in the consumer price index to:

- 3 per cent by the end of 1992
- 2½ per cent by the middle of 1994
- 2 per cent by the end of 1995.
- Thereafter, the objective would be further reductions in inflation until price stability was achieved. While a good deal of work has already been done on what stability in the general level of prices means operationally, a more precise definition of price stability has not been specified in the event that further evidence and analysis become available over the next few years.[1]

Monetary policy formulation involves the choice of a path of monetary expansion consistent with achieving the policy objectives embodied in the inflation-reduction targets. In determining the path and the appropriate monetary conditions to bring it about, the Bank assesses financial and economic developments in Canada and abroad. This process involves meetings with industry associations and individual companies, liaison with financial market participants, and a wide range of other contacts, along with the examination of economic and financial statistics.

To keep abreast of international developments, and as part of its involvement in international financial matters, the Bank participates in international meetings, including those of the finance ministers and central bank governors of the Group of Seven Countries (the G-7), the Organisation for Economic Co-operation and Development, the Bank for International Settlements and the International Monetary Fund (IMF).

On the basis of information gathered from both domestic and international sources, supplemented by studies on how the economy works, economists at the Bank prepare analyses of economic and financial developments. These feed directly into the process for making decisions about monetary policy.

Senior staff also discuss policy issues and progress in meeting objectives with a variety of groups in Canada. In 1991 the Governor gave six formal speeches to groups representing a cross-section of the economy from Vancouver to Saint John, and he appeared on two occasions before parliamentary committees. As well, the Governor and senior officers of the Bank met informally on more than 125 occasions during the year with academics, interest groups, industry and financial groups, and provincial

[1] For more discussion of the inflation-reduction targets see "Background note on the targets," *Bank of Canada Review*, March 1991, and "Targets for reducing inflation: Further operational and measurement considerations," *Bank of Canada Review*, September 1991.

public servants across the country, exchanging information on the state of the national and regional economies.

Bank staff on occasion provide technical assistance to developing countries, typically through the IMF. As well, the Bank has agreed to provide technical assistance under the auspices of the IMF to the central banks of the Eastern European reforming economies and the republics of the former Soviet Union.

Banking activities

Under the *Bank of Canada Act*, the Bank undertakes a variety of banking activities. These are mainly operations supporting the implementation of monetary policy and the provision of banking services for the government and other clients.

Implementation of monetary policy

The implementation of monetary policy involves bringing about the setting of monetary conditions consistent with the desired path of monetary expansion. The Bank's ability to affect monetary conditions flows primarily from its influence on the rate of financing in the overnight market. This influence comes about mainly through its daily decisions on the availability of settlement balances to financial institutions directly involved in the clearing of cheques and other payment items. As discussed earlier in the section of this report on the Bank's monetary policy operations, actions to adjust the quantity of these balances are supplemented from time to time with special financing arrangements (Special Purchase and Resale Agreements and Sale and Repurchase Agreements) for designated money market participants and with outright purchases or sales of Government of Canada treasury bills.[2]

In 1991, the Bank made purchases, net of maturities, of $32.9 billion of newly-issued treasury bills. Its purchases were used primarily in open market operations, although it also sold over $6.3 billion to clients (central banks, Government of Canada accounts and international agencies). After taking account of net sales in the market for monetary policy purposes, the Bank's holdings of bills increased by almost $2.6 billion during the year. These assets were acquired in the main as the counterpart to the increase in the Bank's liabilities for bank notes and deposits of financial institutions.

Managing the federal government's cash position

The Bank actively manages the government's cash balances, in conjunction with the Department of Finance, in order to minimize the cost of the government's liquidity and debt service requirements. The regular treasury bill tender varied in 1991 from week to week between $5 billion and $7.2 billion, depending on cash needs. Using the cash management swap technique introduced in 1991, the Exchange Fund Account (EFA) swapped some of its foreign currency assets for Canadian dollars with Canadian banks for terms from one day to three months. This arrangement helped to reduce the need for cash management bills (treasury bills with terms shorter than three months – as short as 11 days in 1991). Thus, there were 11 issues of these bills in 1991, totalling $13.5 billion, against 22 issues totalling $24 billion in 1990. In addition, in order to limit the government's demand deposit balances to the minimum necessary cushion for implementing monetary policy and for government payments, cash balances in excess of daily requirements were auctioned to direct clearers for specific terms of one to ten days; the daily amount outstanding of such term balances averaged $1.9 billion in 1991, and ranged between none and $6.4 billion. Shares of demand deposits were auctioned to the direct clearers for each semi-monthly reserve-averaging period.[3]

Exchange Fund Account

The Bank, acting on behalf of the Minister of Finance, intervenes in the foreign exchange market to help maintain orderly conditions and manages the asset portfolio of the

[2] For further discussion of the Bank's primary technique for implementing monetary policy see "Bank of Canada cash management: The main technique for implementing monetary policy," *Bank of Canada Review*, January 1991.

[3] See "Receiver General deposit auctions: A technical note," *Bank of Canada Review*, August 1991.

Exchange Fund Account. Intervention in the market generally involves the purchase or sale of U.S. dollars in exchange for Canadian dollars. As well, the Bank intervenes in other currencies, notably German marks and Japanese yen, usually in concert with central banks of other major industrial countries (the G-7). With the higher level of official reserves in recent years, the resources devoted by the Bank to managing the portfolio have increased, including the acquisition of automated systems for reserve investment decisions.

Canada's official reserves declined by the equivalent of U.S.$1,679 million in 1991, to U.S.$16,901 million at year-end. This decline was more than accounted for by the introduction of EFA cash management swaps, discussed above, of which U.S.$2 billion were outstanding at year-end. As well, there were net repayments of U.S.$929 million of Canada Bills, issued in the United States, bringing the amount outstanding at the end of 1991 to U.S.$38.5 million.

Foreign central banks

The Bank of Canada maintains deposit accounts for 57 foreign central banks, thereby facilitating the official transactions that these banks or their governments may have in Canadian dollars. In 1991, the Bank of Canada entered into an agreement with the central bank of Mexico which provided for establishment of a reciprocal standby currency facility and for regular consultation on financial and economic matters. There have been no drawings on the facility. A similar facility has been in place with the U.S. Federal Reserve Bank of New York since 1962. As well, with the concurrence of the Minister of Finance, the Bank participated with monetary authorities of other industrial countries in a bridge-financing arrangement for Romania. Canada's share in this multilateral facility, which was related to IMF financing, was U.S.$10 million. Romania fully repaid all drawings under the facility prior to maturity.

Other banking activities

The Bank of Canada acts as registrar of Notices of Intention by the chartered banks to take security for loans, in the form of certain classes of equipment and inventory, under Section 178 of the *Bank Act*. As well, unclaimed chartered bank balances are transferred to the Bank for custody after being inactive for ten years; the central records of these balances may be reviewed by the public free of charge at any Bank of Canada Agency. This regime for unclaimed balances will be extended to federally incorporated trust and loan companies under the new federal legislation.

The Bank plays an advisory role with respect to the regulation and supervision of financial institutions. To ensure close co-ordination between the Bank's lender of last resort responsibility and the supervisory activities of the Office of the Superintendent of Financial Institutions, the Governor is an *ex officio* member of the Financial Institutions Supervisory Committee, chaired by the Superintendent. The Governor is also an *ex officio* member of the Board of Directors of the Canada Deposit Insurance Corporation.

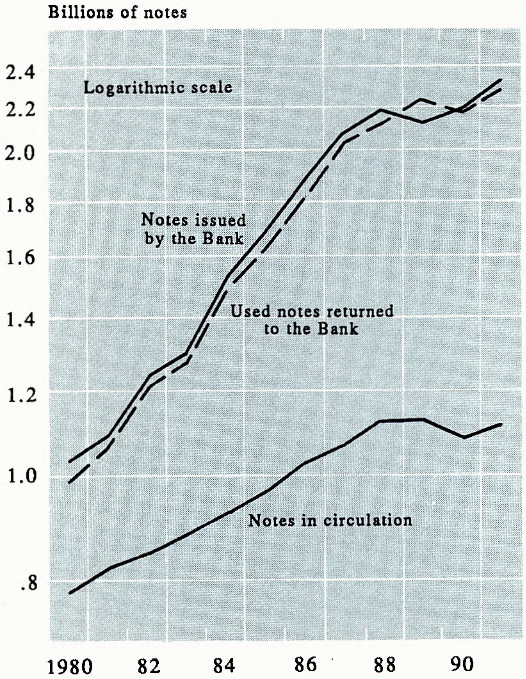
To ensure proper risk management in Canada's clearing and settlement systems and to meet its own operating requirements, the Bank is involved in a number of areas: it is co-operating with other members of the Canadian Payments Association in an examination of proposals for a large-value transfer system; it is co-operating with the Canadian Depository for Securities in the development of a debt clearing service to handle the clearing and settlement of debt and money market securities transactions; it is a member of committees set up in Canada to study the feasibility of implementing the recommendations of the report of the Group of Thirty on clearing and settlement systems for securities transactions; and it is involved in discussions with financial institutions concerning a multilateral foreign exchange netting mechanism.

Bank note issue

The Bank must ensure that the need for bank notes is met in an effective manner across the country and that the notes are readily accepted without concerns about counterfeiting. Notes are issued by the Bank to meet the public's demand for additional notes and to replace worn notes taken out of circulation. Besides issuing new notes, the Bank reissues used notes still fit for circulation that have been returned by financial institutions that find themselves with an excess supply. At the end of 1991, the value of notes in circulation amounted to $24.5 billion, some 90 per cent of the Bank of Canada's total liabilities.

The volume of notes processed by the

Bank notes



Bank, at its Agencies across the country, increased again in 1991 following a pause after the Bank stopped issuing the $1 note in mid-1989. Over 4.5 billion notes were processed, reflecting withdrawals of notes by financial institutions and the return of used notes to the Bank by those institutions.

Note processing is heaviest at the Montreal and Toronto Agencies, each of which accounted for over one-quarter of the total in 1991. Since the present facilities were built, in 1950 in Montreal and in 1958 in Toronto, the volume of bank notes processed in each of these centres has increased about tenfold. In order to handle current volumes more efficiently, as well as projected increases in volumes, the Bank is constructing new cash processing centres outside the financial core in both Montreal and Toronto. These centres will use newer technology that will improve productivity. The new Montreal operations centre is scheduled to be fully operational by mid-1993 and the Toronto centre about a year later.

As part of its program to deter counterfeiting, the Bank is acquiring additional equipment to produce its Optical Security Device (OSD) and to apply it to bank notes. This equipment is required in order to include the OSD on a new $20 note, planned to be issued in 1993. The $20 note is the most heavily used Canadian note, accounting for over 30 per cent of the total number of notes in circulation. The OSD is already applied to the new $50 and $100 notes, introduced in 1989 and 1990.

Management of Government of Canada debt

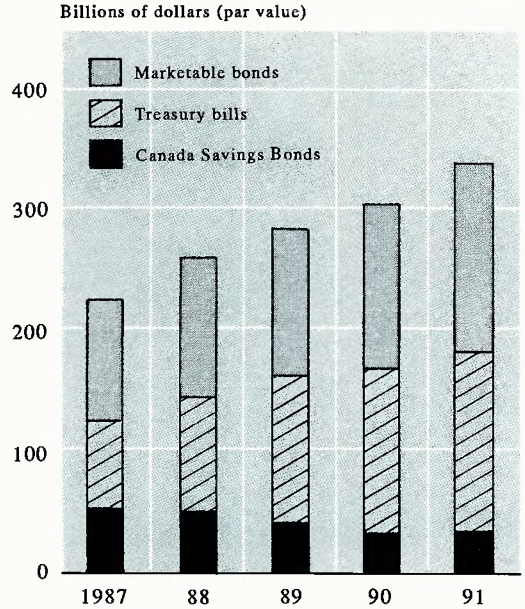
As statutory fiscal agent for the government, the Bank of Canada acts as adviser and administrator for new debt issues and is responsible for servicing and eventually redeeming outstanding debt. In 1991, the government's Canadian dollar market debt outstanding – marketable bonds, treasury bills and Canada Savings Bonds – increased by $32.6 billion to $340.7 billion.[4] Over one-half of the increase in outstanding debt was in the form of marketable bonds, which rose to 46.2 per cent of the total. Nearly 75 per cent of the dollar value of the bond program was sold at auction, with the rest distributed on a fixed-price basis by syndicates of investment dealers and banks. The program included the first issue, $700 million, of Real Return Bonds, whose nominal return is linked to the consumer price index.

Treasury bills were relied on to a somewhat lesser extent in 1991 than in 1990 and their proportion of the outstanding domestic market debt decreased from the record level of 43.9 per cent in 1990 to 43.3 per cent. The average term of the marketable portion of the outstanding domestic debt (bonds and treasury bills) rose by 4 months, to 4 years and 5 months. The proportion of the Canadian dollar market debt on which interest rates are adjusted within a year (including $4.9 billion of Canadian dollar interest rate swaps outstanding at the end of 1991) declined during the year from 60.6 per cent to 59.7 per cent.

The amount of Canada Savings Bonds (CSBs) outstanding rose by $1.4 billion in 1991

[4] In addition, the government debt included foreign currency debt and non-market debt issued to Government of Canada accounts, almost all of it to superannuation accounts.

Outstanding stock of Canadian dollar market debt



following two years of significant declines. Gross sales of the new issue of CSBs were $9.6 billion. Nonetheless, the proportion of outstanding domestic market debt in the form of CSBs decreased further, to 10.5 per cent, less than half of the proportion at the recent peak in 1987.

The Bank is responsible for the integrity of the domestic public debt records and for the accuracy and efficiency of the payments it makes on behalf of the government for interest and debt redemption. The volume of processing involved in administering the debt decreased in 1991 for the second year in a row. The reductions were related to both CSBs and marketable bonds.

CSBs account for three-quarters or more of the total processing volume each year. In 1991, there was a further substantial reduction in the number of CSB certificates redeemed. However, this was partly offset by the larger CSB sales and by an increase in servicing activity, as the Bank was required, starting with the 1990 series, to begin reporting to CSB holders accrued interest income each year on compound-interest CSBs.

A decrease in the past two years in processing related to marketable bonds has mainly been the result of the inclusion of these bonds in the computerized clearing and settlement systems of the Canadian Depository for Securities. This initiative has led to a substantial decline in the number of certificates processed as well as a consolidation of interest payments.

The Bank is developing an automated register for marketable government bonds to replace the current paper-based system. This change will provide a more effective and secure processing environment than is possible with a manual system.

BANK OF CANADA OPERATING EXPENSES

The Bank of Canada operates under the management of a Board of Directors. The Board approves objectives, plans and the budget for the Bank after reviewing proposals to ensure that activities are carried out effectively and economically.

The plan of activities and the budget for 1991, which were approved in December 1990, were subsequently modified to ensure that the level of expenditures would be fully consistent with the federal government's expenditure restraint program introduced on 26 February 1991. A number of projects were postponed or cancelled and staff requirements were curtailed in order to constrain expenditures in 1991. In addition to reducing the 1991 budget, the Board approved an objective of holding the average annual growth in operating expenses below 3 per cent over the next five years. Within this target, the Bank must accommodate the impact of the construction and future use of the new cash processing centres in Montreal and Toronto, as well as the introduction of a new $20 note incorporating the Optical Security Device. In order to accommodate above-average growth rates in 1994 and 1995 when the peak impact of these projects will occur, the growth in operating expenses will have to be held below 3 per cent in 1992 and 1993.

The Bank's operating expenses for 1991 came in below budget and were held to the 1990 level. Apart from the effect of the GST, expenses were 2 per cent lower than in 1990. The composition of the Bank's operating expenses is shown in the following table.

Operating expenses
Millions of dollars

	1991	1990
Staff expenses	97.5	96.0
Bank note costs	41.7	41.5
Other expenses	49.2	48.4
Depreciation	17.2	20.1
Operating expenses	205.6	206.0

In 1991, the total salary bill rose by less than 2 per cent. An increase in wage rates and salary ranges approved at the end of 1990 and a shift in the mix of skills employed resulted in an increase in the average salary paid. At the same time, total staff years employed during 1991 (including temporary, part-time and overtime work but excluding staff engaged in maintaining the premises) fell from 2,301 to 2,193, a decline of 4.7 per cent from 1990.

For 1992, there will be a further decline in staff years employed of almost one per cent, and there is no increase in wage rates or in salary ranges. Senior managers' salaries are frozen. For other salaried staff, individual salary levels were reviewed under the Bank's compensation policy and adjustments within salary ranges were made in those cases where the salary level was not consistent with the level of performance. In total these adjustments were comparable to the annual step increases that take place within the salary ranges for federal government employees.

Bank note expenditures are mainly for the purchase and shipping across the country of new bills printed for the Bank by the B A Banknote and the Canadian Bank Note companies in Ottawa. The number of Optical Security Devices produced and applied to notes continued to rise in 1991 with the growing number of new $50 and $100 notes issued. In addition, about 5 per cent of the bank note expenditures reflect the costs of research to improve security features and processing. Recently developed equipment has enabled the Bank to recover and reissue a higher proportion of the used notes it receives on deposit and to reduce the orders for new notes.

A significant factor adding to the "Other expenses" of the Bank in 1991 was the initial costs associated with a shift to external suppliers of cleaning services for the Bank's buildings. Savings from the contracting out of this work are expected to be $1.5 million in 1992 and $2 million annually thereafter.

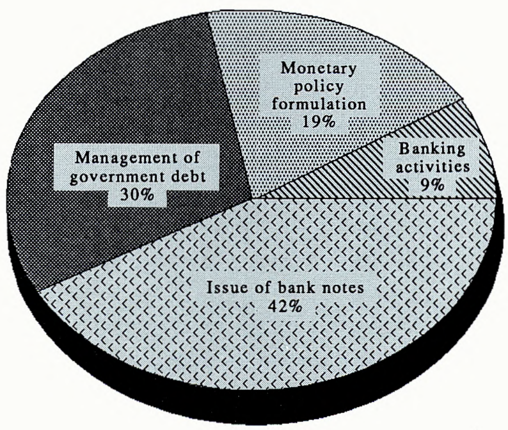
The depreciation charge for the use of buildings and equipment fell in 1991 following the large initial allowance for depreciation associated with a major replacement of computers in 1990. However, depreciation expenses will rise over the next few years as the new cash centres in Montreal and Toronto are completed and equipped, and additional equipment is brought on stream to produce and apply Optical Security Devices.

The Bank has taken action to increase the recovery of costs for providing certain services and is examining the feasibility of further steps in this direction. The fees charged for wire transfers and other same-day services relating to Government of Canada bond transactions were extended in 1991 to include treasury bills. An entrance fee to the Bank's Currency Museum was introduced in 1991. Authority has been sought to adjust the fees charged for the registration of the intention to pledge certain assets for loan security under Section 178 of the *Bank Act*.

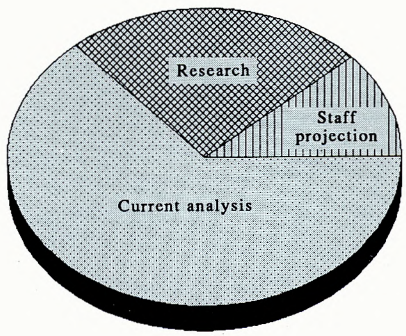
* * * * *

Operating cost by function

The following chart shows how the Bank's total operating costs of $205.6 million are allocated to its major functions:

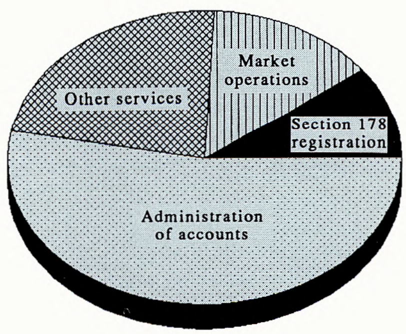


Monetary policy formulation



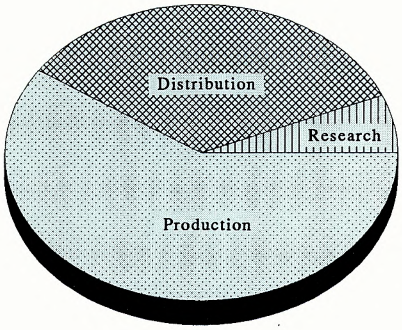
Operating costs related to the formulation of monetary policy amounted to about $39 million in 1991. About three-quarters of the total was related to the assessment of financial and economic conditions in Canada and abroad and the economic outlook. The balance of the costs was associated with more in-depth research into the operation of the economy and financial markets.

Banking activities



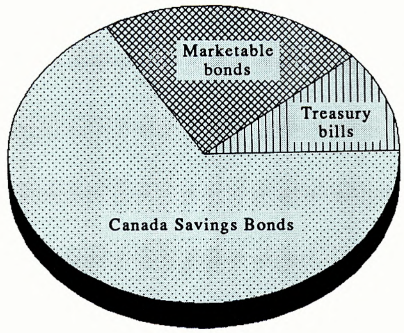
The net cost of banking activities was almost $19 million for the year. About two-thirds of these costs were for the administration of accounts and market operations where there is little scope for cost recovery. "Other services" accounted for almost one-quarter of banking activity costs and related mainly to advances to members of the Canadian Payments Association, administration of unclaimed bank balances and management of the national currency collection and museum.

Issue of bank notes



The operating costs associated with the issue of bank notes totalled $86 million. The production costs, representing about 60 per cent, included the purchase of new notes and the cost of producing and applying an Optical Security Device to the higher denomination notes. Distribution costs, the next largest component, related to the transport of new notes to the Bank's Agencies, processing of orders and returns of notes from banks. Research costs mainly reflected the development of bank note security features.

Management of government debt



The cost of managing the Government of Canada debt totalled $62 million. By law, the Bank provides such fiscal agency services without charge, with the level of these activities dependent upon the government's requirements. About two-thirds of the total costs were associated with the processing of Canada Savings Bonds, which are much more widely held than marketable bonds and treasury bills.

FINANCIAL STATEMENTS

AUDITORS OF THE BANK OF CANADA

VERIFICATEURS DE LA BANQUE DU CANADA

RAYMOND, CHABOT, MARTIN, PARÉ

PEAT MARWICK THORNE

AUDITORS' REPORT

We have audited the statement of assets and liabilities of the Bank of Canada as at December 31, 1991 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at December 31, 1991 and the results of its operations for the year then ended in accordance with the accompanying summary of significant accounting policies applied on a basis consistent with the preceding year.

Raymond, Chabot, Martin, Paré

Peat Marwick Thorne.

Chartered Accountants

Ottawa, Canada

January 24, 1992

Bank of Canada
Statement of revenue and expense

Year ended 31 December 1991 (with comparative figures for 1990)

	1991	1990
	Millions of dollars	
REVENUE:		
Revenue from investments, net of interest paid on deposits of $39.0 ($46.7 in 1990)	**$2,324.4**	$2,614.5
OPERATING EXPENSES:		
Staff expenses (note 2):		
Salaries	**$ 80.2**	$ 78.9
Contributions to pension and insurance funds	**11.8**	10.9
Travel and staff transfers	**2.7**	3.4
Other staff expenses	**2.8**	2.8
	97.5	96.0
Bank note costs	**41.7**	41.5
Other expenses:		
Premises maintenance – net of rental income	**21.2**	19.8
Taxes – municipal and business	**10.9**	10.3
Directors' fees	**0.1**	0.1
Auditors' fees and expenses	**0.6**	0.6
Data processing and computer costs	**7.5**	7.8
Printing of publications	**0.7**	0.8
Other printing and stationery	**2.0**	2.4
Postage and express	**1.7**	1.7
Telecommunications	**1.9**	2.0
Other expenses – net (note 3)	**2.6**	2.9
	49.2	48.4
Depreciation on buildings and equipment	**17.2**	20.1
	205.6	206.0
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**$2,118.8**	$2,408.5

(See accompanying notes to the financial statements)

Bank of Canada
Statement of assets and liabilities

As at 31 December 1991
(with comparative figures for 1990)

ASSETS	1991	1990
	Millions of dollars	
Deposits payable in foreign currencies:		
U.S.A. dollars	$ 230.7	$ 343.8
Other currencies	6.2	24.0
	236.9	367.8
Advances to members of the Canadian Payments Association (note 8)	1,173.9	470.7
Investments — at amortized values:		
Treasury bills of Canada	12,819.1	10,247.8
Other securities issued or guaranteed by Canada maturing within three years	3,920.1	3,997.2
Other securities issued or guaranteed by Canada not maturing within three years	5,356.6	5,753.4
Other investments	3,002.9	3,863.7
	25,098.7	23,862.1
Bank premises (note 4)	196.6	167.6
Other assets	339.0	406.3
	$27,045.1	$25,274.5

(See accompanying notes to the financial statements)

LIABILITIES	1991	1990
	Millions of dollars	
Capital paid up (note 5)	**$ 5.0**	$ 5.0
Rest fund (note 6)	**25.0**	25.0
Notes in circulation	**24,481.4**	22,970.0
Deposits:		
Government of Canada	**21.0**	10.6
Chartered banks	**1,617.9**	1,458.3
Other members of the Canadian Payments Association	**133.6**	134.0
Other deposits	**559.4**	405.8
	2,331.9	2,008.7
Liabilities payable in foreign currencies:		
Government of Canada	**95.6**	210.4
Other liabilities	**106.2**	55.4
	$27,045.1	$25,274.5

Governor, **J. W. CROW**

Chief Accountant, **J.-P. AUBRY**

Bank of Canada
Notes to the financial statements

Year ended 31 December 1991

1. **Significant accounting policies:**

The financial statements of the Bank conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's by-laws. The significant accounting policies of the Bank are:

a) **Revenues and expenses:**

Revenues and expenses are accounted for on the accrual basis except for interest on advances to a bank ordered to be wound up where interest is recorded as received.

b) **Investments:**

Investments, consisting mainly of Government of Canada treasury bills and bonds, are recorded at cost adjusted for amortization of purchase discounts and premiums. The amortization as well as gains and losses on disposition are included in revenue.

c) **Translation of foreign currencies:**

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at the year-end. Gains and losses from translation of, and transactions in, foreign currencies are included in revenue.

d) **Bank premises:**

Bank premises, consisting of land, buildings and equipment, are recorded at cost less accumulated depreciation. Depreciation is calculated on the declining balance method using the following annual rates:

Asset	Rate
Buildings	5%
Computer equipment	35%
Other equipment	20%

A full year of depreciation is charged against assets in the year of acquisition, except for Projects in progress which are depreciated from the point of substantial completion. No depreciation is taken on assets in the year of disposal.

e) **Pension plan:**

Pension plan expense is recorded on the basis of the Bank's contributions. Actuarial surpluses or deficiencies, if any, are amortized over periods not exceeding those provided for by the Pension Benefits Standards Act, 1985, and the regular contributions are adjusted accordingly.

f) **Insurance:**

The Bank does not insure against direct risks of loss to the Bank, except for potential liabilities to third parties and where there are legal or contractual obligations to carry insurance. Any costs arising from these risks are recorded in the accounts at the time they can be reasonably estimated.

2. **Staff expenses:**

Wages and benefits of Bank staff engaged in premises maintenance are not included in this category but rather as part of the Premises maintenance expenses.

3. **Other expenses - net:**

Other expenses - net includes expenses recovered through fees for a variety of services provided by the Bank. In the past, these recoveries ($0.7 million in both 1990 and 1991) were recorded in Revenue.

4. Bank premises:

	1991			1990		
	Millions of dollars					
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Land and buildings	**$174.6**	**$ 79.2**	**$ 95.4**	$173.8	$ 74.3	$ 99.5
Computer equipment	**43.4**	**31.7**	**11.7**	40.6	25.5	15.1
Other equipment	**68.6**	**44.2**	**24.4**	62.9	38.2	24.7
	286.6	**155.1**	**131.5**	277.3	138.0	139.3
Projects in progress	**65.1**	**–**	**65.1**	28.3	–	28.3
	$351.7	**$155.1**	**$196.6**	$305.6	$138.0	$167.6

5. Capital:

The authorized capital of the Bank is $5.0 million divided into 100,000 shares of the par value of $50 each. The shares are fully paid and in accordance with the Bank of Canada Act have been issued to the Minister of Finance, who is holding them on behalf of Canada.

6. Rest fund:

The rest fund was established by the Bank of Canada Act and represents the general reserve of the Bank. In accordance with the Act, the rest fund was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955. Subsequently, all net revenues have been paid to the Receiver General for Canada.

7. Commitments:

As at 31 December 1991, outstanding commitments under contracts for new buildings and equipment totalled $65 million. These contracts call for payments over the next three years and pertain to the Bank's responsibility for the issuance of bank notes.

8. Legal matters:

Advances include a total of $29.5 million ($29.6 million in 1990) provided to the Canadian Commercial Bank and the Northland Bank for which winding-up orders have been issued by the courts. On the basis of the available information, it is the opinion of the Bank of Canada that this amount will be fully repaid from the proceeds of the liquidations.

The Bank of Canada's security for these advances includes the loan portfolios of those institutions. In the case of the Canadian Commercial Bank, two issues are being considered by the courts. On 14 March 1991, the Alberta Court of Appeal reversed the decision of the Alberta Court of Queen's Bench and ruled that interest received from the loan portfolio does form part of the Bank of Canada's security. On 14 November 1991, leave was granted to the liquidator to appeal this decision to the Supreme Court of Canada. The liquidator's conclusion that loans made by the Canadian Commercial Bank in California form part of the Bank of Canada's security has been challenged and this issue is to be tried in the Alberta Court of Queen's Bench. In the event of a final legal determination that all of the interest or all of the California loan portfolio is not included in the security, it could result in some adjustment to amounts which have been recorded in income. The information available at the present time is not sufficient to estimate the potential magnitude of such an adjustment.

BOARD OF DIRECTORS

John W. Crow	Governor *Member of the Executive Committee*
Gordon G. Thiessen	Senior Deputy Governor *Member of the Executive Committee*
Jalynn H. Bennett	TORONTO, ONTARIO *Member of the Executive Committee*
John T. Douglas	NEW GLASGOW, NOVA SCOTIA
William A. Graham	LONDON, ONTARIO
Brian R. Heidecker	CORONATION, ALBERTA *Member of the Executive Committee*
Frederick E. Hyndman	CHARLOTTETOWN, PRINCE EDWARD ISLAND *Member of the Executive Committee*
Harold W. Lane, Q.C.	SASKATOON, SASKATCHEWAN
Leslie M. Little, Q.C.	VANCOUVER, BRITISH COLUMBIA *Member of the Executive Committee*
James A. MacMurray	SAINT JOHN, NEW BRUNSWICK
Nancy Orr-Gaucher	WESTMOUNT, QUEBEC
Susan H. Patten	ST. JOHN'S, NEWFOUNDLAND
Ernest G. Penner	STEINBACH, MANITOBA

Ex officio

Frederick W. Gorbet	Deputy Minister of Finance *Member of the Executive Committee*

SENIOR OFFICERS

John W. Crow, *Governor*
Gordon G. Thiessen, *Senior Deputy Governor*

J. N. Ross Wilson, *Deputy Governor*
Charles Freedman, *Deputy Governor*
Alvin C. Lamb, *Director of Administration*
Frank Faure, *Adviser*
W. Paul Jenkins, *Adviser*
William E. Alexander, *Adviser*

Bernard Bonin, *Deputy Governor*
William R. White, *Deputy Governor*
Serge Vachon, *Adviser*[1]
Tim E. Noël, *Adviser*
Louise Vaillancourt-Châtillon, *Adviser and Secretary*
John E. H. Conder, *Adviser*
†see below

Associate Advisers
Jacques Clément, *Chief, Securities, Montreal Div.*
Donald R. Stephenson

Securities Department
Vaughn O'Regan, *Chief*
R. Bruce Montador, *Deputy Chief*
Ian D. Clunie, *Chief, Market Analysis and Open Market Operations*
James F. Dingle, *Securities Adviser*[2]
Patrick E. Demerse, *Securities Adviser*
Stephen L. Harris, *Securities Adviser*
Donald R. Cameron, *Chief, Toronto Division*

Research Department
Pierre Duguay, *Chief*
Stephen S. Poloz, *Deputy Chief*
David E. Rose, *Research Adviser*

Department of Monetary and Financial Analysis
David J. Longworth, *Chief*
John G. Selody, *Deputy Chief*
Clyde A. Goodlet, *Research Adviser*
Kevin Clinton, *Research Adviser*

International Department
John D. Murray, *Chief*
Brian P.J. O'Reilly, *Deputy Chief*
Nicholas Close, *Chief, Foreign Exchange Operations*
Paul R. Fenton, *Research Adviser*

Department of Banking Operations
Donald G. M. Bennett, *Chief*
Roy L. Flett, *Associate Chief*
William R. Melbourn, *Deputy Chief*
Gordon B. May, *Deputy Chief*

Public Debt Department
Bonnie J. Schwab, *Chief*

Secretary's Department
L. Theodore Requard, *Chief*
Guy Thériault, *Deputy Secretary*
DEBT SYSTEMS
James M. McCormack, *Program Co-ordinator*

Automation Services Department
Daniel W. MacDonald, *Chief*
F. J. Bruce Turner, *Deputy Chief*

Personnel Department
George M. Pike, *Chief*
Claude J.-B. Montambault, *Deputy Chief*

Department of Premises Management
Colin Stephenson, *Chief*

Comptroller's Department
Jean-Pierre Aubry, *Comptroller and Chief Accountant*
Frank J. Mahoney, *Deputy Comptroller*

Audit Department
Janet Cosier, *Auditor*
Peter Koppe, *Deputy Auditor*

1. Also Chairman of the Board of Directors of the Canadian Payments Association
2. Also Alternate Chairman of the Board of Directors of the Canadian Payments Association

† Jacques A. Bussières, Adviser to the Governor, is on a leave of absence. He is serving as Governor of the Bank of Zambia.

REGIONAL REPRESENTATIVES AND AGENCIES

Financial Market Representatives

Securities and International Departments

Montreal
Jacques Clément, *Chief, Montreal Division*
Toronto
Donald R. Cameron, *Chief, Toronto Division*
D. J. S. Morgan, *Foreign Exchange Adviser*
Vancouver
Ritha Khemani, *Representative*

Regional Agents

Department of Banking Operations

Halifax
Robert E. Burgess
Saint John
Kenneth T. McGill
Montreal
J. G. Michel Sabourin
Ottawa
Robert Dupont
Toronto
William G. Percival
Winnipeg
Harry S. Hooper
Regina
Graham L. Page
Calgary
Claude P. Desautels
Vancouver
William H. Watson